Corrections and Additions

Brief:

The following are the citations for cases, which were not available to us when the brief went to press:

Burnet v. Commonwealth Imp. Co., 287 U. S. 415, 77 L. ed. 399;

Burnet v. Huff, 288 U. S. 156, 77 L. ed. 670;

Burnet v. S. & L. Bldg. Corp., 288 U. S. 406, 77 L. ed. 861;

Mass. M. L. Ins. Co. v. U. S., 288 U. S. 269, 77 L. ed. 739;

Murphy Oil Co. v. Burnet, 287 U. S. 299, 77 L. ed. 318;

Tait v. Western Maryland Ry. Co., 289 U. S. 620, 77 L. ed. 1405.

Page 40: Add to the *American Can* case, *Peyton DuPont Securities Co. v. Commissioner*, 66 F. (2d) 718 (C. C. A. 7).

Page 41: Add to the *Kirby Lumber* and *Old Colony* cases, *Welch v. Helvering*, ...U. S....., 78 L. ed. 1 (Adv. Op., Oct. Term 1933, No. 33).

Pages 41 and 42: Compare, on the proposition that the test is not expressed in the statute but is left to be worked out by the practicalities of the business facts, *Welch v. Helvering*, supra.

Page 52: Add to the *Miller & Vidor* case, *Peyton DuPont Securities Co. v. Commissioner*, supra.

Page 60, line 20, should read: "to prevent again taxing income" etc.

Page 66, line 21, last word should be "methods".

Appendix:

Page xiii: The citation for *U. S. v. Anderson* should read, "269 U. S. 422, 70 L. ed. 347".

Page xxii, line 1: Should read "Then come".

Page xxxviii: The volume of the Journal of Accountancy in which Senator Hebert's article appears is Vol. XL, August 1925, No. 2.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1933

No. 187.

ARTHUR M. BROWN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

I.

MATTER SOUGHT TO BE REVIEWED AND OPINION BELOW.

This matter is here on certiorari to review a judgment of the Circuit Court of Appeals for the Ninth Circuit, which affirmed three orders of the United States Board of Tax Appeals assessing deficiencies as to petitioner's income taxes for 1923, 1925 and 1926.

The opinions of the Circuit Court of Appeals are reported in 63 F. (2d) 66. The judgment will be found in

the record at page 282. The opinions will be found in the record at pages 274-281.

The findings and opinion of the United States Board of Tax Appeals are reported in 22 B. T. A, 678. The findings and opinion will be found in the record at pages 54-69, and the "decisions" will be found in the record, pages 70-72.

II.

GROUNDS OF JURISDICTION AND PROCEDURAL HISTORY.

The respondent assessed deficiencies as to petitioner's income tax for 1923, 1925 and 1926. Petitioner applied to the United States Board of Tax Appeals for relief. The Board assessed deficiencies in the same amounts as had respondent. On petition for review to the Circuit Court of Appeals for the Ninth Circuit that Court affirmed the orders of the Board. Accordingly, this matter is here agreeably to §1003 of the Act of Feb. 26, 1926 (44 Stat. 110; 26 U. S. C. §1226), §240 of the Judicial Code (36 Stat. 1157, as amended by 43 Stat. 938; 28 U. S. C. §347), and §8 of the Act of Feb. 13, 1925 (43 Stat. 940; 28 U. S. C. §350).

The judgment and opinions of the Circuit Court of Appeals for the Ninth Circuit were entered February 6, 1933 (R. 281-283). Rule 29 of that Court provides that "a petition for rehearing may be presented within 30 days after judgment". A petition for rehearing was filed on March 8, 1933, and denied on March 21, 1933 (R. 283). The petition for certiorari was filed in this Court

and the cause docketed on June 19, 1933, and the order allowing it was entered October 9, 1933.

The following were the procedural steps up to the determination of the Circuit Court of Appeals.

(a) Petitioner, as an individual, made return for his income tax for 1923, 1925, and 1926. Respondent assessed deficiencies: $17,923.03 for 1923, by his "60 day letter" of Dec. 22, 1927 (R. 20-25), $1,520.19 for 1925, by his "60 day letter" of Apr. 28, 1928 (R. 35-37), and $944.30 for 1926, by his "60 day letter" of Feb. 7, 1929 (R. 47-52).

(b) In due time, pursuant to §274 of the Revenue Acts 1924 and 1926 (43 Stat. 297, 44 Stat. 59; 26 U. S. C. §1048), and §272 of the Revenue Act of 1928 (45 Stat. 852; 26 U. S. C. §2272), petitioner filed petitions with the Board of Tax Appeals, for redetermination of the deficiencies. The petitions were filed, as to the 1923 tax, on Feb. 20, 1928 (Docket No. 35305; R. 11-25), as to the 1925 tax, on Jun. 6, 1928 (Docket No. 39157; R. 26-37), and as to the 1926 tax, on Apr. 8, 1929 (Docket No. 43432; R. 39-52). Respondent filed answers on Apr. 20, 1928 (R. 25-26), Aug. 6, 1928 (R. 37-38), and May 31, 1929 (R. 52-53). All three matters were set for hearing on May 14, 1930 (R. 1, 5, 9). At that time they were consolidated (R. 114-116). On Mar. 11, 1931 the Board promulgated its "Findings of Fact and Opinion" (R. 54-69; 115; 2, 5, 9). On Apr. 25, 1931, decisions, pursuant to the findings and opinion, were entered (R. 70-72; 2, 5-6, 9; 115).

(c) Agreeably to the Acts of Congress (Act of Feb. 26, 1926, §§1001 (as amended by Act of May 29, 1928,

§603, 45 Stat. 873), 1002, 1003, and 1005, 44 Stat. 109-110; 26 U. S. C. §§1224-1228), and to Rule 38 of the Circuit Court of Appeals, for the Ninth Circuit, petitioner, an inhabitant of the Ninth Circuit, petitioned that court to review said decisions. Separate petitions, containing assignments of error, were filed in each matter on Sept. 8, 1931 (R. 80-91; 93-101; 103-112), and notice duly given (R. 91-92; 102-103; 112-113). Pursuant to stipulations that the three matters might be consolidated for review and presented on one record (R. 73-80; 115), petitioner had settled and filed his "Consolidated Statement of Evidence" (R. 114-263). A single transcript was prepared. Pursuant to stipulation and order exhibits not set out in the statement of evidence were omitted in printing the record, with leave to refer to any matters in unprinted exhibits if set out in the briefs (R. 268-269).

III.

SUMMARY STATEMENT AND ISSUES PRESENTED.

In 1923, 1925, and 1926 petitioner was in receipt of income coming from the "overriding commissions" of an insurance general agency business. "Overriding commission" was in every case a percentage of the premium of policies written. It was paid as compensation for services performed throughout the life of the policies. The policies were for one, three and five years. On cancellation of a policy before its normal termination the general agent was required to refund a proportionate part of his overriding commission, determined by the proportionate part of the premium returned. Part of the

"overriding commission" income shown on the books in any one year was as to that year unearned and would be refunded. The amount of this refund could be accurately foretold from past experience.

The books were kept on the accrual basis. The full overriding commission, whether actually received or not, was shown in the year in which the policy was written. Admittedly, petitioner is not to be taxed on the part of the overriding commissions refunded.

The question is as to the proper method of return of overriding commission retained and on which a tax is to be paid—as to how the amount to be returned in any annual accounting period is to be fixed. More precisely, the question is which of the following methods of return should be used:

(a) Returning the full amount of commission shown on the books in the year in question, less, not the part of *that* commission to be returned, but, on the contrary, the actual cash return of commission in that year (being referable both to policies written in the year in question, and hence shown as a receipt in the year in question, and to policies written in an earlier year, and shown as a receipt in an earlier year). *This is treating commission received on an accrual basis and the commission refunded on a cash basis.* This is the method used by respondent.

(b) Returning the full amount of commission shown on the books in the year in question, less the liability to return a part of that on cancellation of the policies, which liability attached the moment the commission was entered on the books. The amount of liability set up

was dictated by experience. This is the method used in making the return.

(c) Returning only the amount of commission *earned* in any one year (whether referable to policies written in that year, or written in earlier years) by prorating the commission over the life of the policies. This was an alternative method urged by the petitioner before the Board and before the Circuit Court of Appeals.

IV.

STATUTES AND REGULATIONS INVOLVED.

The statutes involved are provisions of the Revenue Acts of 1921, 1924, and 1926. (Reference in each instance is made to the sections by which these provisions are carried into the Revenue Acts of 1928 and 1932.) The quotations are taken from Title 26, U. S. Code, except as to the Act of 1921.

(a) Revenue Act of 1921, §200 (4), (42 Stat. 227; Fed. Stat. Ann. 1921, 123) provided:

> "The term 'paid' for the purposes of deductions and credits under this title, means 'paid or accrued' or 'paid or incurred', and the terms 'paid or incurred' and 'paid or accrued' *shall be construed according to the method of accounting upon the basis of which the net income is computed under §212.*"

The Revenue Acts of 1924 and 1926, §200 (d) (43 Stat. 254, 44 Stat. 10; Fed. Stat. Ann., 1924, 82; 26 U. S. C., §931) provided:

> "*The terms 'paid or incurred' and 'paid or accrued', shall be construed according to the method of*

computing upon the basis of which the net income is computed under §953 or §984. The deductions and credits provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid *or incurred', dependent upon the method of accounting* upon the basis of which the net income is computed under §953 or §984, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

(See Revenue Acts of 1928 and 1932, §§43, 48 (c); 45 Stat. 805, 807; 26 U. S. C., §§2043, 2048; 47 Stat. 185, 187, 26 U. S. C., §§3043, 3048.)

(b) Revenue Acts of 1921, 1924 and 1926, §212 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 133; 43 Stat. 267, Fed. Stat. Ann. 1924, 94; 44 Stat. 23, 26 U. S. C. §953) provided:

"(a) In the case of an individual the term 'net income' means the gross income as defined in section 954 of this title, less the deductions allowed by sections 937 and 955.

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period, (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

(See Revenue Acts of 1928 and 1932, §§21, 41; 45 Stat. 797, 805, 26 U. S. C., §§2021, 2041; 47 Stat. 178, 185, 26 U. S. C., §§3021, 3041.)

(c) Revenue Acts of 1921, 1924 and 1926, §213 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 134; 43 Stat. 267, Fed. Stat. Ann. 1924, 95; 44 Stat. 23, 26 U. S. C., §954), after specifying items included in gross income, provided:

> "The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer *unless, under methods of accounting permitted under subdivision* (b) *of section 953, any such amounts are to be properly accounted for as of a different period.*"
>
> (See Revenue Acts of 1928 and 1932, §42; 45 Stat. 805, 26 U. S. C., §2042; 47 Stat. 185, 26 U. S. C., §3042.)

(d) Revenue Acts of 1921, 1924 and 1926, §214 (42 Stat. 227, et seq., Fed. Stat. Ann. 1921, 135; 43 Stat. 269, Fed. Stat. Ann. 1924, 97; 44 Stat. 26, 26 U. S. C., §955) provided:

> "(a) In computing the net income there shall be allowed as deductions:
>
> "(1) All the ordinary and necessary expenses paid *or incurred* during the taxable year in carrying on any trade or business, * * *"
>
> (See Revenue Acts of 1928 and 1932, §23; 45 Stat. 799, 26 U. S. C., §2023; 47 Stat. 179, 26 U. S. C., §3023.)

(e) The Regulations involved are set out in Appendix A, pages i to ix below.

V.

STATEMENT OF FACTS.

Edward Brown & Sons.

Before 1923, and during the years here in question, a business of acting as insurance general agent was conducted in San Francisco under the name, Edward Brown & Sons. From 1904, until August 1922, when Herbert H. Brown died, this business was conducted by Arthur M. Brown, the petitioner, and his brother, Herbert H. Brown. After the death of Herbert H. Brown, the business was conducted by Arthur M. Brown alone, until January 1, 1924. On this later date, petitioner's son, Arthur M. Brown, Jr., was admitted as a partner. Thereafter, the business was conducted by petitioner and his son, as partners (R. 56, 125, 130, 131).

The income here in question is from this business. For 1923, it is the income of petitioner doing business as Edward Brown & Sons. For 1925 and 1926 it is petitioner's share of the partnership income of petitioner and his son doing business as Edward Brown & Sons.

Edward Brown & Sons were Pacific Coast General Agent for six fire insurance companies. The relations with four of the companies were defined by writings. Three of these contracts were introduced in evidence, that with the Brand & Lifforsakrings Aktiebolaget Svea (Svea Fire and Life Insurance Company, Ltd., of Gothenburg, Sweden) as petitioner's Exhibit 5 (R. 131, et seq.), that with the Agricultural Insurance Company as petitioner's Exhibit 6 (R. 146, et seq.), and that with the Hudson Insurance Company as petitioner's Exhibit 7 (R. 154, et seq.).

The contract with the United States Merchants & Shippers Insurance Company (known as United States Lloyds) had been lost. It was a copy of the Agricultural contract (R. 165).

The relations with the other two companies, the Hamilton Fire Insurance Company and the Globe & Rutgers Fire Insurance Company, were defined by oral agreement and acts of the parties—conversations and course of dealings. As to them it was agreed commissions should be paid upon net premium writings—gross premiums less cancellations and reinsurance—and that the agent should appoint and cancel agencies, supervise underwritings, endorsements, cancellations, collections, and adjustment of losses, and generally should represent the companies and attend to all of their affairs. The business of all of the companies was conducted in exactly the same way (R. 165, 166).

For the finding of the Board as to the truth of the foregoing see record, page 60.

Functions of a General Agent—Local Agents Distinguished.

Edward Brown & Sons, as general agent, was appointed directly by the companies. The general agent in turn appointed local agents. The duty of the general agent is to manage the company's business and to do its underwriting. The local agent is the solicitor—the man who directly gets the business. (See the statutes set out in Appendix C, pages xiv to xviii.) With this, Edward Brown & Sons, as general agent, had nothing to do (R. 125, 167-169). Any duty with respect to the direct solicita-

tion of business is conspicuous by its absence in the written contracts between the general agent and the companies. For what, then, is the general agent employed? The Board found:

> "The duties required of and performed by the firm were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; received and acknowledged service of proof of loss; issued, countersigned and cancelled policies; received and receipted for premiums, surveyed all risks offered and accepted or rejected the same; represented its principals on the Pacific Board of Fire Underwriters; computed and paid commissions due local agents; ceded or reinsured certain lines of business with treaty or other companies; computed and paid return premiums on cancelled policies; secured return of premium on cancelled reinsurance; rendered all reports required of its principals by the authorities of political subdivisions in the territory in which it operated; attended to the payment of all license fees and taxes; furnished all necessary printed matter, except policy blanks, to local agents; transferred insurance by endorsement; determined whether its principals should participate in special pools; and generally attended to all of the affairs of its principals in the territory in which it operated."
>
> (R. 60, 61.)

The service that Edward Brown & Sons performed was running and operating the whole of the business of the companies which they represented. The contract with the Svea (petitioner's Exhibit 5) in paragraph II expressly appoints Edward Brown & Sons as "general

agents'' for eleven states, two territories and British Columbia, specifies certain duties to be performed and provides that the general agent is ''to transact such other business as usually pertains to a general agency of a fire insurance company''. The agent agrees ''to faithfully perform the duties which usually devolve upon general agents''. The contract with the Agricultural contains almost word for word the same provision. The provision in the Hudson contract, Article II (petitioner's Exhibit 7) is even broader, providing that the agent is ''generally to conduct the business of said company'' in accordance with directions.

In actual practice, as has already been pointed out, all companies were handled alike. The whole of the business was in the hands of Edward Brown & Sons. Nothing was referred back to the home offices (R. 179)—nothing is done in relation to the companies other than to make net remittances to them after all expenses and deductions and losses have been taken from the premium income. No consultation is had with them on any detail, —only on general matters of policy (R. 177-178).

Such service is not related to any particular period in the life of any policy. It extends over the whole of the policy's life. Particularization and examination of the precise services rendered confirm this statement.

The general agent takes all such steps as may be necessary to qualify his company, where it is a foreign corporation, to do an insurance business (R. 168). When the business is first begun, and while he conducts business, he has full ''authority to appoint and remove agents''

(see Exhibits 5, 6, and 7 and R. 169), and of course is charged with the duty of supervision of the local agents. For this the general agent has special employees known as field men (R. 168, 169).

The agents must have necessary forms and stationery. With the exception of the policy blanks and reports of the company, these are furnished by the general agent (R. 168, 169-171). This matter involves considerable responsibility. Riders are used for the purpose of varying and adopting the standard forms of policies to the specific insurance risk. The general agent supervises the supplying and use of these. The form of rider is determined by the Standard Forms Bureau of the Board of Underwriters. This is an organization made up of the standard insurance companies. The companies for whom the general agent acts are represented on that Board by the general agent. The petitioner here, acting for his companies, not only acted on many of the committees of the Board of Underwriters, but was the Chairman of the Standard Forms Bureau (R. 170, 171).

The local agent is not in a position unaided to conduct business. The general agent supplies him with servicing and information service. Field men assist local agents in obtaining business, make surveys, assist them in rating risks, and otherwise do anything that will push the agent's business (R. 169, 170).

When the local agent issues the policy, the general agent must scrutinize it—determine that the correct form, riders, and endorsements have been used, and check the rate. The general agent's functions are different with two

different types of agents. The recording agents, the larger ones who have a thorough knowledge of the business, are permitted to sign policies. There are others, non-recording agents, who are not equipped to issue policies. They send their applications to the general agent where the policies are written. These policies are then returned to the non-recording agent to be countersigned. The compensation of the general agent is the same whether the local agent be a recording or a non-recording agent (R. 170-171).

The policy written, the general agent must and does survey the risk and determines whether or not the risk will be accepted or rejected. This is a matter entirely in the hands of the general agent—it is not referred back to the home office. In practice many risks submitted by local agents are rejected (R. 171).

The next duty is in connection with the collection of the premium. Under its contracts the general agent is given power to "receive and receipt for premiums"; indeed, is obligated to its companies to see that they are paid. It is the general agent's loss if they are not paid (R. 171). It guarantees "the payment to the" insurance company "of all premiums on policies issued by them or their agents" (Exhibit 5, paragraph III; Exhibit 6, paragraph Fifth; Exhibit 7, Article III). The premium must be checked and computed by the general agent and is usually collected within sixty days. The general agent computes and allows for the commission of the local agent after the premium has finally been determined, and makes up the necessary statements in this behalf (R. 171).

When the foregoing services have been completed the insurance has been written and paid for. This does not end the services of the general agent. He has in his hands the matter of reinsurance. If a line or risk written is in excess of what either the company or general agent believes advisable, the liability must be reduced. (See, for example, paragraph IV of Svea contract, petitioner's Exhibit 5; paragraph Sixth of Agricultural contract, petitioner's Exhibit 6.) This can be reduced by reducing the policy, or by insuring part of the excess with other companies. In 99% of the cases reinsurance is effected. There are companies known as "treaties" or "treaty companies". Such a company is simply a reinsurance company for the company which originally writes the risk, and is so called because, by fixed arrangement between the parent company and the treaty, the treaty is entitled to the first line of reinsurance over and above the net line of the parent company. Reference to such treaties will be found in the written contracts introduced in evidence. There is, however, a very large amount of reinsurance that is not controlled by these treaty arrangements. Except for this matter of treaty arrangements the whole matter of reinsurance is in the hands of the general agent. Where there is no treaty the general agent determines both the amount of reinsurance and with whom it is to be placed. Where there is a treaty the general agent must still exercise judgment as to the amount of the reinsurance. The whole matter is in his control—it is not submitted to the companies for their approval (R. 171, 172).

Such reinsurance is effected whenever the particular risk represents an excess. This by no means always occurs when the policy is written. Changes in conditions may create an excess in a risk where there was no excess at the time the risk was first written. Again, a risk may be reinsured in another company and that company cancel. The reinsurance must be replaced. After a policy is written, it may be desirable to get rid of the risk entirely without cancelling the policy; again reinsurance must be effected. This would happen where the company had written a full net line and later a new line, more desirable, and in the same location, would be written (R. 172, 173, where a specific example of this will be found). Sometimes reinsurance is effected with another company represented by the general agent. At other times it is with outside companies (R. 172). Whenever this reinsurance is effected, cancelled, or changed, the general agent is charged with caring for the payment of the premium and the return of the unearned premium. For none of these services connected with reinsurance is the general agent paid any compensation beyond his overriding commission (R. 172, 173). On the contrary, in figuring the net premiums on which his commission is based reinsurance is deducted (R. 166; petitioner's Exhibits 5, 6 and 7). The general agent throughout the life of every policy must be on constant guard to see that the proper reinsurance has been effected, watching not only his own risks but the status of the reinsurance as well.

Reinsurance is a method of changing the company's risk without changing the policy originally written. After

originally written, however, not only may the risk covered by the policy change, necessitating adjustment, but the policy itself may require change. It is done by endorsement. An example of this would be where property is sold and the insurance is transferred by endorsement. Other changes of this nature will suggest themselves. No further compensation is paid for this service.

The matter does not stop with the endorsement. The endorsement may affect the rate. It may decrease the rate, in which event the general agent must refund part of his overriding commission. This costs him money. It is possible that the rate may be increased. In this case the general agent obtains overriding commission upon the increase. *This is the only time where, after a policy is originally written, the compensation of the general agent is changed by the receipt of further compensation* (R. 175, 176). And all of the mechanics which must be gone over in the case of the original writing of a policy, must be gone over for each of these changes—that is, the checking, computation, collection, remittances and reinsurance (R. 176).

Two other things may happen, after the policy is written, matters of loss aside for the moment. The policy may be cancelled. Unearned premium must then be returned. This matter is handled by the general agent, using his own funds. This will be referred to again. Reinsurance may be cancelled. This is wholly controlled by the general agent (R. 176).

In the event of a loss, the general agent has important duties. The written contracts expressly authorize him

"to receive and acknowledge service of proof of loss", "to adjust losses under the policies" of the companies, and in the event of litigation, "to accept service of process" (petitioner's Exhibits 5, 6 and 7). All technical requirements must be handled. All of the papers scrutinized. Investigation of the loss must be made. At times this requires months. The general agent determines what losses shall be paid. These matters are not referred to the companies. The agent determines whether in the event of litigation he will continue to refuse to pay. In the event of litigation he controls it on behalf of his companies. They bear the legal expenses but the agent receives no further compensation for his own services (R. 177).

No suggestion is required to point out the important and delicate function the general agent performs in handling losses. Not only must he protect his companies, so far as the assured is concerned, but it of course devolves upon him, when a loss has been paid, to see to it that collection is made from companies which have reinsured part of the risk, and, where possible, to recoup any salvage. The mere suggestion that the general agent has in charge the handling of losses will indicate the very minute, painstaking, thorough-going, untiring service which he performs.

So far we have been dealing with services which may be said to be on the assured's side of the handling of insurance. There are further services to be performed upon the company's side.

Supervision of the local agents has been suggested. As pointed out in the written contracts with the com-

panies, the local agents are required to report their business to the general agent. These reports must be checked and digested. The general agent must then promptly forward to the home office "bordereaux" of risks written, endorsements, changes upon policies, all changes in agents or risks, and all other matters, particularly losses. The Hudson contract required weekly reports. One of these bordereaux, covering only premiums and return premiums (R. 190) for one company, for three months, was produced before the Board showing the nature of the reports made and the meticulous care and detail required (R. 173, 174, 175). Without extra compensation a statistical department is maintained (R. 175). The significance of such a department needs no comment.

Not only must reports be made to the companies but municipal, state and federal authorities require reports. These are made by the general agent (R. 175, 176). All matters of local license, taxes, and things of that sort, with the exception of the fact that two of the companies pay the state taxes directly, are handled by the general agent (R. 175).

The most important function performed by the general agent, which requires continued, intensive and exhaustive effort, is the constant checking of all risks within the territory. He must keep himself so informed that he can intelligently determine whether or not a risk shall be accepted. He must carefully watch all classes of risks in all localities, to determine whether or not business continues to be profitable, once it has been written. If conditions change liability can be ended. The companies

have no control over this (R. 176, 177). The general agent employs and sends out engineers and field men to inspect the risks. Markets and general conditions are watched; new buildings and changed physical conditions must be investigated and checked. Maps of the whole territory are kept in detail, by blocks for every city and town of any importance. Moral and financial standing of the assured is investigated and to this end the general agent is a member of credit rating bureaus.

Akin to this service, because it depends upon the nature of the risk, is the fixing of rates. This is done by the Board of Underwriters. The agent represents his company on this Board.

There are risks which a single company cannot insure. Pools are formed. The participation in such pools is in the hands of the general agent (R. 178-9).

In a word, the general agent handles the whole of the business of the company in his territory (See *Vance, Insurance,* 2 ed. 416). This, in the case of Edward Brown & Sons, was so much so that it required an investment of $250,000 for them to run the business of their companies. On occasions they have had to pay losses out of their own funds and borrow money to operate their companies (R. 178). Edward Brown & Sons were not reimbursed by the companies for interest paid—they received only the original commission paid.

The general agent is a wholesaler of insurance. In a given territory he is the manager of his companies. The local agent is the solicitor of insurance. When the local

agent procures the business and the policy is written, his functions end. It is at this point that the general agent's functions begin. At every moment while a policy is current he has duties as to that policy—his functions are performed throughout the life of the policies and are referable to the policies in force. The existence of outstanding policies is the only justification for the general agent.

Compensation Paid to Agents—General Agents and Local Agents Distinguished.

The compensation of the local agent is a policy commission, or commission for getting business. It is fixed by an independent organization, the Board of Underwriters (R. 126).

Edward Brown & Sons operated not only in California but in other western states, British Columbia, Alaska, Territory of Hawaii, and the Philippine Islands. (See Exhibits 5, 6, and 7, and as to the Globe & Rutgers and the Hamilton see R. 166, 167.) In many of these places statutes required that all policies be signed by a local *resident* agent. In some instances it was expressly provided that he should "receive the full commission when the premium is paid".

Idaho, Compiled Statutes, §5009, Statutes of 1915, Chapter 145, §2, p. 318, (R. 167);

California, Political Code, §633d;

Province of British Columbia, Insurance Act, Acts of 1925, Chapter 20; 1926-1927, Chapter 35; 1928, Chapter 19, consolidated as the Insurance Act, August 17, 1928, §§149, 160, 183-186, 197;

Nevada Revised Laws, §1304, as amended by Statutes 1919, 392;

Montana Code, §6118, Insurance Laws of the State of Montana, Compiled by Insurance Department, 1929, p. 29;

Wyoming, Insurance Laws, §11, Laws, 1921, Chapter 142, §3;

Oregon, Insurance Laws, §4, Olson, Oregon Laws, §6333, Laws 1923, Chapter 115, §1, p. 172.

Excerpts from these statutes are set out in Appendix C. This enumeration is not exhaustive.

Whether such statutes were in force or not, the same rule was followed by Edward Brown & Sons. In all cases a local agent received the policy commission (R. 167, 168).

The compensation of Edward Brown & Sons was fixed by the contract with the companies. The general agent received a contingent "commission"—a percentage of net earnings, if any, on the business written through the general agent—and an "overriding commission"—that is, a percentage of the premium over and above, and irrespective of, the commission paid to any local agent (R. 126). The overriding commission is a percentage of the *net* premiums on business written through the general agent. Net premiums are gross premiums, less cancellations (by the company or by the assured), and less net reinsurance effected (R. 246, 247, 257, 166, and Exhibits 5, 6, and 7). The general agent made monthly remittances of the premiums for which he was accountable, less commissions allowed, including his own overriding commission.

No question arises here with respect to the contingent commission.

Return Commission.

All policies issued through Edward Brown & Sons were cancellable at the option of the assured, "short-rate," or at the option of the company, on pro rata repayment of the unearned premium. The forms of policies used were introduced as petitioner's Exhibits 1 and 2. No form for British Columbia was available, but cancellation there is covered by subdivision 10 of §142 of the Insurance Act. This was read into the record (R. 124). The forms in many states are fixed by statute:

California: Statute 1909, p. 404; Deering, General Laws (1923), Act 3735;

Oregon: Olson's Laws, §6458; L. 1911, c. 175 §1, p. 279. See for special provisions as to cancellation, Insurance Laws, §22-i; L. 1917, c. 203; §22-i, p. 362; Olson's Laws, §6394;

Hawaii: Revised Laws 1925, §3451;

British Col.: Insurance Act, supra, §142;

Idaho: Comp. Stats., §5053;

Wyoming: Insurance Code, §95, L. 1921, Ch. 142, §18.

The foregoing enumeration is not exhaustive.

The New York Standard Form is the basis for all forms of fire policies. Its provision for cancellation is as follows:

> "This policy shall be cancelled at any time at the request of the insured; or by the company by giving five days' notice of such cancellation. If this policy

shall be cancelled as hereinbefore provided, or become void or cease, the premium having been actually paid, the unearned portion shall be returned on surrender of this policy or last renewal, this company retaining the customary short rate; except that when this policy is cancelled by this company by giving notice it shall retain only the pro rata premium."

This privilege of cancellation has an immediate and important effect upon the compensation paid the general agent. *Whenever there is a cancellation and a return of a portion of the premium the general agent must return a corresponding portion of his commission.* It is this consideration which ties the time element into the earning of his overriding commission. That commission is directly related to the life of the policy, because, on cancellation of the policy, a proportionate refund must be made, and because the compensation is for services, as indicated, running over the life of the policy.

This results because overriding commission is figured on *net* premiums. Net premiums result only after cancellations and reinsurance have been deducted. (See Exhibit 5, par. V; Exhibit 6, par. Seventh; Exhibit 7, Art. VI. Compare the special exceptions stated in the event of a rate war and cancellations through general reduction of rates—Exhibit 5, par. VII, Exhibit 6, par. Ninth, Exhibit 7, Art. X). The Hudson contract had an express provision on the subject (Exhibit 7, Art. III). An express provision is not necessary, however, where commission is a percentage of *net* premiums. As a matter of law the commission is not fixed until all cancellations

and reinsurance have been determined. If the agent has been overpaid he must make refund even though the cancellations are effected after termination of the agency.

Milwaukee Mechanics Ins. Co., v. Warren, 150 Cal. 346;

National Union Fire Ins. Co., v. Nason, 21 Cal. App. 297.

So long as the agency continues, the necessary adjustments are made by appropriate entries in arriving at the amount due on periodic settlements. This is not so after the agency ends. Edward Brown & Sons, between 1923 and 1926, had an experience which brought them within these California cases. Their agency for United States Merchants & Shippers Insurance Company was terminated. They were required to, and actually did, repay portions of commissions received by them but related to the unearned portion of premiums on policies cancelled (R. 179).

The overriding commission of the general agent is only a percentage of the premium income of the company. Like that premium income, it is earned only over the life of the policy. If the policy is prematurely terminated, a proportionate and proper refund must be made. This is known as "return commission".

From long experience, the ratio of cancellations to business written can be predicted, and the relation of return commission to gross commission received accurately fixed. Edward Brown & Sons' own experience showed the proportion of overriding commission on business written

in any year (whether for one, three or five years), of which return would have to be made.

Five Year Period	Gross Fire Premiums Written	Fire Premiums Cancelled	Ratio
1919 to 1923	$14,893,022	$3,333,104	22.38%
1920 to 1924	15,647,482	3,492,101	22.32
1921 to 1925	15,931,443	3,432,670	21.55
1922 to 1926	17,155,359	3,642,071	21.13

(Petitioner's Exhibits Nos. 28-32.)

In the fire insurance business, generally, cancellations run from 20% to 25% (R. 206).

It will be noticed that the percentage of cancellations is arrived at by using five year periods. Compare Treasury Regulations, Art. 91 (Appendix A, p. vi), dealing with redemption of trading stamps.

Methods of Accounting and Making Return.

The books of Edward Brown & Sons were kept on the accrual basis (R. 195, 251, 257). The Board so found (R. 63). This is the standard and accepted method for insurance general agents (R. 251). The method of accounting has never been changed. The methods of return hereafter noticed, however they may differ, required no change in method of keeping the books, nor the changing of any figure on those books (R. 201, 211, 250-252).

The policies written through Edward Brown & Sons were written for one, three, and five years. The exact proportion of each is shown by Exhibits 22, 23, 24, and 27. Accordingly, cancellations took place in years other than the year in which the policy was issued.

Until 1923 return of overriding commission was made by returning overriding commission shown on the books for any one year, less return commission on cancellations effected in that year. This resulted in charging against overriding commission shown for one year on business written in that year, and from premiums accounted for in that year return commission, returned in that year, on cancellation of business written in an earlier year, where the commission, a part of which was returned, was shown for the earlier year as from a premium accounted for in an earlier year. *Under this method return commissions were charged, not against the commissions and the year to which the same related, but against later years.* In the case of return commission relating to policies written for the United States Merchants & Shippers Insurance Company, after termination of the agency for that company, such method would charge return commission, not against that company and the policies to which the same related, but against commissions received on different policies written for wholly different companies.

For 1923, the first year in which petitioner was sole proprietor of the business, conceiving that this method was inaccurate, and that the return commission should be charged against the very commissions which were being returned, and as a charge properly attributable to the process of earning those commisisons, during the period in which they were received (cf. *U. S. v. Anderson*, 269 U. S. 422, 70 L. ed. 347 and Reg. 62, Art. 111, Reg. 74 and 77 Art. 342), petitioner set up a figure on his books (Petitioner's Exhibit No. 31), dictated by past experience

as to cancellations and return commission (page 26 above), representing the liability to return commission, by reason of future cancellations of 1923 business. This was deducted from the commission shown for 1923 in making return. This method was followed for subsequent years.

In making his return in this way, the petitioner did not change the method of accounting. The same method was continued in use in keeping the books. No entries on the books were changed. The figures used are those which appear on the books. The books were kept on the same theory as was used in computing and showing the true income of petitioner. The only thing that was done was to bring the system more nearly in accord with the accrual method by perfecting the system. The returns were made in accordance with the books, and on the same basis as that upon which the books had been kept (R. 201, 211, 232-234, 250-252, 257).

Under this method return commission on account of cancellation of policies written in 1923, where cancellations occurred in later years, was charged, not against commissions received on other policies, written in the year of cancellation, but against this reserve so set up, and since this reserve was charged against commissions on the policies now cancelled, it was charged against the policies and commissions to which it in truth related. This procedure was followed for later years.

This figure so set up and charged—this reserve—was $52,971.96, for 1923. The net additions to the reserve for 1925 and 1926 were $3,292.98 and $1,947.77. These are the figures in dispute. Their disallowance gave rise to

the deficiencies assessed (R. 245-247, Exhibits 14, 15, 16, and 32).

Before the Board petitioner urged, and now urges, a third method suggested by acts of Congress. This is a method of strict actuarial computation, showing when the commissions were earned and returning them only as earned. This method is to return in each year only the compensation earned in that year, computed not by taking commissions shown on the books, less a figure representing the obligation to return part of it on cancellation of policies, which figure is determined from experience, but by taking the actual policies in force in a given year (whether written in that year or not), computing the premiums earned in the year, and so arriving at the compensation earned in that year. This method prorates the commission over the life of each policy, and as it is earned. Exhibits giving the figures on this basis are in evidence (Exhibits 20-28).

This last method, and the method used in making the return, were disallowed. The Commissioner required the petitioner to return his income in accordance with the method used before 1923, with resulting deficiencies. The commission coming in was accounted for under the accrual method—it was shown on the books as the business was written and as the premiums were shown, whether actually collected or not. The Commissioner permitted deduction for "return commission," going out, only as return was actually made. *Thus, the commission coming in is shown on the accrual basis, but the outgo of return commission the respondent insists petitioner shall show on a cash basis.*

VI

SPECIFICATION OF ERRORS.

The court below erred in affirming orders of the Board of Tax Appeals determining any deficiency as to tax due from petitioner on his income for the years 1923, 1925, and 1926 (except as any deficiency may have been assessable for 1923, because of deduction of $3,000 paid to Mrs. Halton, a matter now foreclosed to us), and erred in failing to find that there was no deficiency in the income tax of petitioner for these years. The court erred in affirming orders of the Board of Tax Appeals, charging back to petitioner sums deducted by him as reserve against his liability to refund return commissions, being $52,971.96 for 1923, $3,292.98, partnership income for 1925, and $1,947.77, partnership income for 1926.

The court below erred in affirming orders which compel petitioner to return "return overriding commission" income on a cash disbursement basis, while the books, and particularly the income of overriding commission, were on an accrual basis, and where the accrual basis was "the method of accounting regularly employed in keeping the books."

The court below erred in refusing to permit petitioner to return overriding commission income on an accrual basis, and on such basis to compute it either:

(a) By returning overriding commission income shown on the books for any given year, less an amount, ascertainable on the basis of past experience, representing the liability coincidentally incurred to return a part of this overriding commission on

cancellation of policies to which the same related; or, in the alternative,

(b) By returning overriding commission income only as earned, on a strict actuarial basis.

The court erred in holding that income shown (whether received or not) on books kept under the accrual method is at once subject to the taxpayer's disposition, and so must be returned in the year in which entered on the books, and that the methods suggested by petitioner are only methods of returning at some indefinite future time of petitioner's own selection; that the figures set as reserves and here in question are to cover contingent liabilities; that such figures are not authorized as deductions, and that such figures, arrived at as the figures here were fixed, on the basis of experience are not countenanced as proper subtractions, under the statutes, even where the books are kept on an accrual basis. The court erred in determining that overriding commission was earned when first shown on the books, and not over the lives of the policies to which it was related, and must be returned in the year when so shown, though the books were kept on an accrual basis, though some of it would have to be returned, and though only part of the services for which the same was payment were performed in the year in question. (See record pages 86 et seq., 97 et seq. and 108 et seq.)

VII.

SUMMARY OF ARGUMENT.

Income taxes are imposed for annual periods. Return must be made so as to truly reflect income for each such

period. To this end the statutes have been amended from time to time, particularly to permit the use of the accrual method of accounting. As the result there are two, and only two, methods which can be used—the cash receipt and disbursement method, and the accrual method. Whichever of these methods is selected by the taxpayer as the method for keeping his books must be consistently followed assessing his income tax. This elementary principle was violated by the reassessment made against the petitioner. His books were on an accrual basis, but he was required to treat certain items—return commissions —on a cash disbursement basis.

The purpose of the change in statutes was to permit taxpayers to keep their books and make their return according to scientific accounting principles, by charging against the receivables for a given annual period the expenses incurred in that period and properly attributable to it. There were two methods which could be used here to attain this purpose—(a) by returning gross commissions shown on the books, less a reserve on account of liability to refund a part of that on cancellation of policies to which the same related, or (b) by prorating the commission over the life of the policies to which the same related, and returning it on a strict actuarial basis as earned. Both of these methods are sanctioned by good accounting practice and by the statutes as construed by this court. Both will clearly reflect taxable income. The petitioner should be permitted to use one or the other, although it is submitted that the second method represents the better accounting practice.

VIII.

ARGUMENT.

Under the income tax statutes, gains and losses for tax purposes are computed for annual periods.

> "The scheme of the Revenue Act is an imposition of tax for annual periods, and the exaction for one year is distinct from that for any other."
>
> *Tait v. Western Maryland Ry. Co.*, ...U. S....., 77 L. ed. 906, Adv. Op., Oct. Term 1932, No. 842.

Gains are to be accounted for when realized (whether paid or not), and deductions taken in the year in which sustained—"paid or incurred".

Tait v. Western Maryland Ry. Co., supra;

Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 75 L. ed. 1049;

Burnet v. Sanford & Brooks Co., 282 U. S. 359, 364, 365, 75 L. ed. 383, 387;

Lucas v. Kansas City Structural Steel Co., 281 U. S. 264, 268, 74 L. ed. 848, 851;

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347;

Reg. 62, 65 and 69, Art. 22, Appendix A, p. ii.

We believe, with deference, that this elementary principle was lost sight of below.

In making a return for any annual period, the basic rule is that return shall be made in such a way as to clearly reflect taxable income. To this end, the Revenue Acts have been amended from time to time. These amendments have immediate bearing on the matter at hand.

History of the Statutory Provisions Involved.

The prototypes of the income tax statutes were the Corporation Excise Tax Act of Aug. 5, 1909 (chap. 6, 36 Stat. 11, 112) and the Corporation Income Tax Act of Oct. 3, 1913 (chap 16, §II, subd. G, 38 Stat. 114, 172). These statutes made no provision for the accrual system of accounting. Though some necessary departures were permitted (see *Maryland Casualty Co. v. U. S.*, 251 U. S. 342, 64 L. ed. 297), the general scheme was of a return on a cash receipts and disbursements basis (*U. S. v. Anderson*, 269 U. S. 422, 438, 70 L. ed. 347, 350.) The statutes did not in terms permit deduction of accounts payable, nor provide for the use of inventories. (*Aluminum Castings Co. v. Routzahn*, 282 U. S. 92, 96-97, 75 L. ed. 234, 236.)

Such a scheme could not work. Necessity required that the Treasury Department issue regulations under which inventories and accounts receivable and accounts payable could be drawn into the calculations. What has been called a mongrel system of accounting and return grew up. By 1916 the situation compelled the attention of Congress. In dealing with the problem in the Revenue Act of 1916 the Committee on Ways and Means (House Report, No. 922, 64th Cong., 1st Sess., p. 4) reported:

> "As two systems of bookkeeping are in use in the United States, one based on the cash or receipts basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income."

The Revenue Act of 1916, §§8(g) and 13(d) (39 Stat. 756, 761, 770) authorized taxpayers "keeping accounts on any basis other than that of actual receipts and disbursements" to make return on such basis. Notwithstanding this option it was "the purpose of the Act to require returns that clearly reflect taxable income" (*U. S. v. Mitchell*, 271 U. S. 9, 12, 70 L. ed. 799, 801). Even under this Act, it has been held "that the return must be filed on the accrual basis" "where true income can not be arrived at on the basis of actual receipts and disbursements" (*Aluminum Castings Co. v. Routzahn*, supra).

The Treasury Department, on January 8, 1917, issued new regulations under the Revenue Act of 1916. (Treasury Decision 2433, Appendix B, pp. x to xiii.) These were held in *U. S. v. Anderson*, 269 U. S. 422, 438, 70 L. ed. 347, 350, to be a correct interpretation of the Act, "consistent with its purpose and intent", and "in harmony" with §13(d). (See Appendix B, p. xiii.) Then by the Revenue Act of 1918 (Feb. 24, 1919, chap. 18, 40 Stat. at L. 1058, 1064, §§200, 212) it was made mandatory for taxpayers to use their bookkeeping basis as the basis for making return. A provision like that in the Revenue Act of 1918 is found in all of the later acts. The effect was to introduce the accrual method of accounting as a basis for making return.

Niles Bement Pond Co. v. U. S., 281 U. S. 357, 74 L. ed. 901;

Aluminum Castings Co. v. Routzahn, 24 F. (2d) 230; 31 F. (2d) 669 (C. C. A. 6); 282 U. S. 92, 75 L. ed. 234.

"The regulations of the Treasury under all the Revenue Acts since 1916 have required taxpayers to report on the cash or accrual basis, depending on which method was pursued in their accounting. Since the adoption of the Revenue Act of 1921 (1918?) the requirement has been statutory. It is settled beyond cavil that taxpayers other than insurance companies may not accrue receipts and treat expenditures on a cash basis, or vice versa. Nor may they accrue a portion of income and deal with the remainder on a cash basis, nor take deductions partly on one and partly on the other basis."

Mass. M. L. Ins. Co. v. U. S., 288 U. S. 269, 77 L. ed. 435 (Adv. Op., Oct. Term 1932, No. 322).

The statutory change sanctioned the use of induction in accounting for tax purposes, within such limits as were fixed by good accounting practice.

The result is that "prior to the Act of 1926 the Revenue Acts definitely recognized only two bases for tax returns—cash and accrual". (*Burnet v. S. & L. Bldg. Corp.*, 288 U. S. 406, 77 L. ed. 617—Adv. Op., Oct. Term 1932, No. 475.) The changes from 1926 on do not affect the foregoing generalization, so far as this case is concerned.

At about the time the question of proper accounting methods for tax purposes was being considered by the Treasury Department and by Congress—consideration reflected in the Acts of 1916 and 1918—the same question was being agitated before the American Institute of Accountants, the Federal Trade Commission, and the Federal Reserve Board. This led to the issuance of a bulletin by the Federal Reserve Board, in April 1917. (See Appendix

D, p. xix.) Excerpts from a revised edition of this bulletin are set out in Appendix D. This bulletin represents the best in modern accounting practice. It calls for accounting on the accrual basis, and goes beyond any position which it is necessary for the petitioner to take in this case.

Under the later Revenue Acts the Treasury Department issued revised regulations. The parts of these regulations referable to the sections of the Revenue Acts of 1921, 1924 and 1926 here involved are set out in Appendix A. The re-enactment of these sections of the earlier acts indicates that Congress has recognized and adopted the established practice of the Department in the interpretation and application of such sections. These regulations have had congressional approval.*

U. S. v. Anderson, 269 U. S. 422, 70 L. ed. 347;
Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 75 L. ed. 1049;
Old Colony R. Co. v. Com'r of Int. Rev., 284 U. S. 552, 76 L. ed. 484;
Murphy Oil Co. v. Burnet, 287 U. S. 299, 77 L. ed. 168 (Adv. Op., Oct. Term 1932, No. 80);
Mass. M. L. Ins. Co. v. U. S., supra, p. 36.

Effect of Revenue Acts—Accounting Method Used Must be Followed Consistently—Respondent Neglected this Rule.

To properly fix the scope and effect of the provisions of the Revenue Acts their purpose must be borne in mind.

*NOTE: In this regard it is to be remembered that all the regulations set out in Appendix A had their prototypes in the same numbered Articles in Regulations 45 issued under the Revenue Act of 1918, except Art. 51 in Reg. 62 was Art. 52 in Reg. 45; Art. 91 in Reg. 62 was Art. 88 in Reg. 45; Reg. 45 contained no Article like Art. 155 of Reg. 62.

In dealing with the purpose of the prototype in the Act of 1916, of the sections here involved, it was said:

> "It was to enable taxpayers to keep their books and make their returns *according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;* • • •.
>
> *"The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year.* The reserve for munitions taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained."

U. S. v. Anderson, 269 U. S. 422, 440, 70 L. ed. 347, 350, quoted in

American National Co. v. U. S., 274 U. S. 99, 104, 71 L. ed. 946, 949;

Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 75 L. ed. 234;

Miller & Vidor Lumber Co. v. Commissioner, 39 F. (2d) 890 (C. C. A. 5), cert. den., 282 U. S. 864, 75 L. ed. 764.

This purpose is attained by the provision that the return shall be made "in accordance with the method of account-

ing regularly employed in keeping the books". For petitioner there were only two methods open—the cash receipts and disbursement method and the accrual method. (*Burnet v. S. & L. Bldg. Corp.*, supra, p. 36.) These two methods are mutually exclusive.

> "It is settled beyond cavil that taxpayers other than insurance companies may not accrue receipts and treat expenditures on a cash basis, or vice versa. Nor may they accrue a portion of income and deal with the remainder on a cash basis, nor take deductions partly on one and partly on the other basis."
>
> *Mass M. L. Ins. Co. v. U. S.*, supra, p. 36.

Accord:

U. S. v. Anderson, supra;

Niles Bement Pond Co. v. U. S., 281 U. S. 357, 359; 74 L. ed. 901, 903, quoting T. D. 2433;

Aluminum Castings Co. Routzahn, 282 U. S. 92, 75 L. ed. 234, quoting T. D. 2433;

See: T. D. 2433, Appendix B, p. xii.

Our position is that which the Government successfully maintained in *Aluminum Castings Co. v. Routzahn*, supra. In the Government's brief Solicitor General Thacher expressed the position as follows:

> "In order that income may be clearly reflected, it is necessary where income is computed on the accrual basis that all items, both of receipts and disbursements, must be consistently included when accrued, whether paid or received or not. This plain economic fact has been asserted in the administrative regulations of the Treasury Department, the validity

of which has been recognized in the decisions of this court.

* * * * * * * * * *

"This court has recognized the fact that if a return is on the accrual basis all items, both of receipts and disbursements, must be included as they accrue, if the return is to reflect income clearly."

This general proposition, without more, makes the respondent's action unjustifiable. The books were kept on the accrual basis. Income was shown, not as received, but as it accrued. "Pecuniary obligations payable to or by the company were treated as if discharged when incurred." (*U. S. v. American Can Co.*, 280 U. S. 412, 74 L. ed. 518.) The taxpayer endeavored to treat a consistently recurring item of outgo so that this item, and the commission coming in, would be handled in accordance with the dominant method used, and the taxable income as a whole shown on a basis in harmony with the accrual method of keeping the books. The attempt at consistency is resisted by the Commissioner. He insists that the item of return commission be treated on a cash basis.

The method used by the commissioner does not have the element of consistent treatment of all items, which is required. It is out of harmony with the bookkeeping method, and erroneous under the settled construction of the statutes.

It remains only to consider whether or not there is any possible method of return adaptable to the facts here, which is in harmony with the Revenues Act, i. e. is in harmony with the accrual method "regularly employed

in keeping the books", and which will truly reflect income. Two such methods exist.

Proper Methods of Return.

The two methods of return, possible here, have received congressional and accounting approval. The first is a strict actuarial method; accruing overriding commission income, by prorating the income over the life of the policies; "deferring" unearned income. The second is by showing overriding commission income as of the time it should be received, and finding income for tax purposes by deducting the liability, which inhered in that receivable, to return part of it on cancellation of policies; deducting "accrued" or "incurred" liability. It is believed that the first of these two methods is the more accurate. Historically, the other came first, and we take it up first, after noticing some general considerations.

(a) Raising revenue is a practical matter. Congress has handled it in an eminently practical way. The statutes have not been burdened by detailed requirements in an endeavor to anticipate the factualities of commercial life. The whole matter is treated by referring it to the bookkeeping method which the taxpayer has adapted to his business needs. The statutes use plain language. That language is to be given its ordinary meaning. (*U. S. v. Kirby Lumber Co.*, 284 U. S. 1, 76 L. ed. 131; *Old Colony R. R. Co. v. Com'r of Int. Rev.*, 284 U. S. 552, 76 L. ed. 484.)

The test in handling any particular item, is itself to be practical. For example, "the requirement that losses be deducted in the year in which they are sustained calls for a practical test". (*Burnet v. Huff*, 288 U. S. 156, 77 L. ed.

478—Adv. Op., Oct. Term 1932, No. 58.) In *Lucas v. American Code Co.*, 280 U. S. 445, 74 L. ed. 538, this court expressly distinguished; said that the time as of which an item should be accounted for called "for a practical, *not a legal,* test".

Revenue requirements may color this practical test. But it still remains that the problem is solved primarily by considering the business significance of the factual elements. The Treasury Regulations recognize this. The regulations are valid

> "unless unreasonable or inconsistent with the statute. They constitute contemporaneous construction by those charged with the administration of the act, are for that reason entitled to respectful consideration, and will not be overruled except for weighty reasons."
>
> *Fawcus Machine Co. v. U. S.*, 282 U. S. 375, 75 L. ed. 397.

The regulations pertinent here (Appendix A) have received congressional approval by the re-enactment, without substantial change, of the sections of the statute to which they are referable. (See p. 37 above.)

Art. 21 (Appendix A, p. ii):

> "*Though taxable net income is a statutory conception it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory 'net income' is commercial 'net income'.* This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer."

Art. 22 (Appendix A, p. ii):

"The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. *If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.*"

Art. 23 (Appendix A, p. iii):

"*Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.* A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See Section 200 of the statute for definitions of 'paid,' 'paid or accrued,' and 'paid or incurred'."

Art. 24 (Appendix A, p. iv):

"*It is recognized that no uniform method of account can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in* HIS *judgment best suited to his purpose.*"

Art. 51 (Appendix A, p. v):

"Gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, *unless they are included when they accrue to him in accordance with the approved method of accounting followed by him.*"

Art. 111 (Appendix A, p. vii):

> "Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, * * *. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year."

When the books of Edward Brown & Sons showed that they were entitled to collect a given amount of commission they did not show that that commission had been collected —the books were on an accrual basis, and commission showed as a receivable, whether received or not. Even if received, it was not gain or profit at its face amount. As a matter of business fact its value was reduced by the obligation concurrently incurred to return a part of it on cancellation of policies. A part of it had to be held available to meet this obligation. This was a matter of business necessity—a prerequisite to continued business life—as well a matter of legal necessity. The contract of the general agent with the companies presupposed and was bottomed on the ability of the general agent to meet this obligation. (2 *Corpus Juris*, 546, §178; 2 *Williston, Contracts*, §880.) The statutes and Regulations, where the books were on the accrual basis, require that this situation be reflected.

As to any particular policy, cancellation depended on a choice of the assured or the company. So far as the obligation of the agent was concerned, it is to be noticed, however, that the happening of this condition, as to any particular policy, was a matter wholly beyond his control. But income taxes are not fixed by consideration of individual items.

"All the revenue acts which have been enacted since the adoption of the 16th Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of *all* the taxpayer's transactions during a fixed accounting period * * *."

Burnet v. Sanford & Brooks Co., 282 U. S. 359, 363, 75 L. ed. 383, 386;

Virginia-Lincoln Furniture Corp. v. Com'r of Int. Rev., 56 F. (2d) 1028—C. C. A. 4.

There is no contingency when the whole of the general agent's business is looked at. As to *him* there was no uncertainty. There was no contingency "in the economic and bookkeeping sense with which the statute" is concerned.

That the item of return commission is properly referable to the year in which the cancelled policy was written, and that it is a charge "incurred in and properly attributable to the process of earning income during that period" is demonstrated by a simple example. Part of overriding commission for business written in 1923 will be returned. On this part no tax is to be paid. Assume part of this is returned in 1924, and that the agency for the company terminated December 31, 1923. If the taxpayer has gone out of business from what is this return to be deducted? If it can be deducted only for the year in which it is returned, and if he then has no income, it avails him nothing; and he has been forced to pay a tax on something which was not a gain or profit to him. If he is to get the benefit of this by filing an amended return for 1923, *then it is because this item is referable to 1923*, and, since on the basis of past experience, its amount could have been fixed with reasonable certainty in 1923, it should have been de-

ducted from 1923 receivables in the first instance! (*Cf.*, *Continental Tie & Lumber Co. v. U. S.*, infra, p. 50).

In actual fact the agency of Edward Brown & Sons for Merchants & Shippers terminated during the years in question. After that termination commission was returned. The respondent is now asking that this return commission be charged against commission received after this termination and related to different policies written for different companies!

The gross receivables, shown on the books of the general agent for a particular year, are not gain or profit to him. Under the accrual method he can show this in two ways. He can show the gross amount of such receivables, less the figure representing the factual and legal obligation to return a part of them; less a reserve for deferred charges. Or he can show these receivables only as earned, by deducting from the gross the part representing unearned and deferred income.

(b) Authority to return the income by showing overriding commission less a reserve for return commission is found in T. D. 2433 (Appendix B—see p. 35 above), as a construction of the Revenue Act of 1916 which followed the provision it construed into the perpetuating sections of the acts of 1921, 1924 and 1926. T. D. 2433 ruled that

> "it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals *approximate as nearly as possible* the actual liabilities for which the accruals are made, * * *.

"In cases wherein, pursuant to the consistent practice of accounting * * * corporations set up and maintain reserves to meet liabilities, *the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred,* it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; * * *."

There is ample accounting authority for this ruling:

Federal Reserve Board Bulletin, "Verification of Financial Statements" (Appendix D, p. xix);

Montgomery, Auditing Theory and Practice (Appendix E, p. xxix);

Montgomery, Federal Tax Handbook, pp. 8 and 9, 14 and 15, 17-21, 21 and 22 (Appendix E, pp. xxx-xxxv);

Finney, Principles of Accounting (Appendix E, p. xxxvi);

Lough, Business Finance (Appendix E, p. xxxvii).

Speaking of T. D. 2433, this court said in *U. S. v. Anderson,* 269 U. S. 422, 439, 70 L. ed. 347, 350:

"It recognized the right of the corporation to deduct all accruals and reserves, *without distinction,* made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income."

Return commission meets the test of a deductible liability within the authorities. It is no answer that there may be uncertainty as to particular items. For income tax purposes the items are to be dealt with as a whole. When so dealt with there is no uncertainty. It is no answer that as to a particular item there is no present liability which can be enforced in an action at law. The test is not a legal test—the test is not the ability to draw and maintain a declaration. If it were *Lucas v. American Code Co.*, 280 U. S. 445, 74 L. ed. 538, must have been decided differently. The test is a practical one. As a matter of business actuality there is no difference between the paying of return commission here and the paying of the "guaranty" in the *American National Company Case*, infra. Whatever was present on the face of the agreements in that case and may not be so expressed here, is here supplied by a permissible process of induction. It is enough that there is a liability reasonably imminent, beyond the control of the taxpayer to change, the amount of which can be foretold with reasonable accuracy.

U. S. v. Anderson, supra;
American National Co. v. U. S., 274 U. S. 99, 71 L. ed. 946;
Lucas v. American Code Co., supra;
Continental Tie & Lumber Co. v. U. S., 286 U. S. 290, 76 L. ed. 1111.

In *U. S. v. Anderson*, supra, it was held that a tax which was not due and payable until 1917 was deductible as accrued in 1916. This court called to attention the part of T. D. 2433 quoted above at pages 46-47, and then, after using the language quoted at pages 35, 38 and 47 said:

> "*In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the tax had accrued.* It should be noted that §13(d) makes no use of the word 'accrue' or 'accrual' but merely provides for a return upon the basis upon which the taxpayers accounts are kept, if it reflects income—which is precisely the return insisted upon by the Government."

American National Co. v. U. S., supra, involved the question of deduction for a liability assumed to pay purchasers of notes 1% per annum for the life of the loan, which in each case was more than a year. It was held that this undertaking was an expense of sale of the loan notes; that:

> "The company's net income for the year could not have been rightly determined without deducting from the gross income reported by the commission notes, the obligations which it incurred under the bonus contracts, and would not have been accurately shown by keeping its books or making its return on the basis of actual receipts and disbursements. The method which it adopted clearly reflected true income. And, just as the aggregate amount of the commission note was properly included in its gross income for the year —although not due and payable until the expiration of two years—so, under the doctrine of the Anderson Case, the total amount of the bonus contracts was deductible as an expense incurred within the year, although it did not 'accrue' in that year in the sense of becoming then due and payable."

Lucas v. American Code Co., supra, presented the question of the deductibility of a "reserve" against liability for claimed breach of contract, where the taxpayer "denied

and strenuously contested" the asserted liability, and where the claimed reserve "had no relation to the apprehend total loss." The claimed deduction was, naturally, disallowed. In the course of its discussion the court said:

> "Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains. Exception is made, however, in the case of losses which are *so reasonably certain in fact and ascertainable in amount* as to justify their deduction, in certain circumstances, before they are absolutely realized. * * * It may be assumed that, since the company kept its books on the accrual basis, the mere fact that the exact amount of the liability had not been definitely fixed in 1919 would not prevent the deduction, as a loss of that year, of the amount later paid."

In *Continental Tie & Lumber Co. v. U. S.*, supra, the question was as to the time of showing an amount to be received by a railroad from the Government and to be fixed by the Interstate Commerce Commission. It was held that it should be drawn into the account for the year when it was determined that some amount would be received, although the exact amount could not be fixed. The court said:

> "The petitioner correctly states that at the date of the Act's adoption no railroad had a vested right in any amount; * * * The petitioner says that at the date of the passage of the act it was impossible to predict that any award would be made to the railway, and, assuming one would eventuate, its amount could not be estimated, * * * The Government

> insists that while adjustments or settlements of principles by the Commission might vary the amount to be awarded, the petitioner's case presented problems not differing from those confronting many business concerns which keep accounts on an accrual basis *and have to estimate for the tax year the amount to be received on transactions undoubtedly allocable to such year.* The case * * * presents the problem whether the taxpayer had in its own books and accounts data to which it could apply the calculations required by the statute and ascertain the quantum of the award within reasonable limits."

In this last case the Government squarely took the position that the "taxpayer should return the *estimated* award." In Law Opinion 1059, Cumulative Bulletin 4, pages 147, 151, the Solicitor of Internal Revenue, citing T. D. 2433, recognized that,

> "few accrued liabilities are estimated with absolute accuracy, and it is generally necessary to make adjustments from time to time in these accounts as the situation requires."

The proper method of return is not different because the figures in question are made up of a multitude of small items, even where there may be uncertainty as to what particular component items will ultimately enter into the final figure, provided that the gross result of all of the items can be foretold with reasonable accuracy.

In *Virginia-Lincoln Furniture Corp. v. Com'r of Int. Rev.*, 56 F. (2d) 1028, (C. C. A. 4), the taxpayer showed accounts receivable at the end of a year. The customers from

whom these accounts were due were permitted certain discounts. A reserve against these discounts, in an amount dictated by experience, was set up and disallowed by the Commissioner. The Circuit Court of Appeals held that the deduction was proper. In answering the very argument which will be urged here, the court said:

> "Even though there be contingencies as to any particular account, if the experience of the company is such that upon the accounts taken as a whole, it is possible to predict with substantial accuracy what the discount will be, a deduction in anticipation of same should be allowed. It is the total of the accounts which is considered in computing income, and, if the discount which will be allowed from this total can be determined with reasonable certainty, there is no reason why the same should not be deducted."

It will be said that this case differs from ours because our commission was actually received and subject to the petitioner's absolute disposition, while in the *Virginia-Lincoln Case* the gross income was not actually received. The attempted distinction falls into error in two respects. There is no showing that the commission we accounted for was in fact received—our books were on the accrual basis and showed simply what we should have received, not what we actually received. Secondly, under the accrual system actual receipts and disbursements cut no figure. "The year of the payment of the interest, and the year when the interest matured, have no importance, where accounting is on the accrual basis." (*Miller & Vidor Lumber Co. v. Com'r of Int. Rev.*, 39 F. (2d) 890—C. C. A. 5.)

The very essence of the accrual system as to income is that it should be accrued, shown, treated as received, and returned as of the time when it was earned, irrespective of when it was received. Income earned and due should be returned though not received. The reverse is true. Money received but not earned is held subject to an obligation, and must be reduced by the amount which is deferred.

In *Alpha Portland Cement Co. v. U. S.*, 67 Ct. Cls. 680, the taxpayer sold cement in sacks, under an agreement to redeem the bags by making a stipulated refund for every bag returned. To meet this it set up on its books a "return-bag liability," and in making its income tax return sought to deduct this. The Commissioner disallowed this. The court sustaining the position of the taxpayer, said:

> "It seems clear that the company's method of book-keeping was calculated clearly to reflect its income, and was within the intent of said Section 212(b). On the other hand it is clear that the Commissioner's method does not reflect but distorts the company's income. The company's method of accounting for its bags provides a necessary and proper consideration of its contractual obligation to refund the charges for the bags made at the time of shipment.
>
> "This obligation was a legal liability, the amount of which was readily ascertainable, for the company's experience, and that of others in the industry, was that 90% of the bags outstanding at the end of 1918 would be returned in the due course of its business.
>
> "In view of the above, it is apparent that to treat more than 10% of plaintiff's 'Return-bag liability' of $41,959.29 as income, would be a plain distortion of plaintiff's income for the year 1918, because 90% of

> the above amount, which sum the experience of the trade shows must be refunded, is 'properly attributable to the process' of earning income during that period."

On similar facts this case was followed in *La Salle Cement Co. v. Com'r of Int. Rev.*, 59 F. (2d) 361, 362-363 (C. C. A. 7—cert. den. 287 U. S. 624, 77 L. ed. 32, Adv. Op.).

There are other considerations indicating the propriety of the method of return used by petitioner. It is conceded in the concurring opinion of the Circuit Court of Appeals, and was conceded in the Government's brief before that court (pages 12 and 28), that the method used by petitioner would reflect income at least as accurately as that urged for respondent. The Treasury Regulations supply us with persuasive analogies. We have set out in Appendix A the Regulations dealing with long-term contracts (page v), redemption of trading stamps (page vi), and bad debts (page ix). It is true that there is now statutory authority for the last. But there was no specific statutory authority when, as a construction of the Revenue Act of 1918, these articles were first incorporated in Regulations 45. We apprehend that the method of accounting for bad debts outlined by the Treasury Department is not robbed of its persuasive force as indicating by analogy what the correct accounting method is here, because it later received congressional approval.

But there is a more persuasive analogy. Through the Revenue Act of 1918, fire insurance companies were required to return their income, as other corporations did

(*Mass. M. L. Ins. v. U. S.*, 288 U. S. 269, 77 L. ed. 435—Adv. Op., Oct. Term 1932, No. 322), except that §12 (39 Stat. 767, as amended; Fed. Stat. Ann. 1918, 329) specifically permitted deduction "in the case of fire insurance companies" of "the net addition, if any, required by law to be made within the year to reserve funds." This court has held that "unearned premium reserve" is a familiar type of insurance reserve, and a strictly technical reserve within the meaning of this statute (*Maryland Casualty Co. v. U. S.*, 251 U. S. 342, 64 L. ed. 297, decided under the Act of 1913). Our overriding commission income is merely a percentage of the premium income of the companies. Our unearned overriding commission reserve is merely a percentage of the unearned premium reserve of the companies. The companies set up a reserve for premiums which must be returned, and we set up a reserve which is a percentage of that, for our share—the return commission.

The fact that this result is arrived at under a particular statute means simply that Congress has determined on an appropriate method of accounting. Congress was not originating or creating a method of accounting—it simply approved pre-existing accounting practice. (See Journal of Accountancy, Audits of Fire Insurance Companies, by Felix Hebert, Appendix E, page xxxviii.) Even though the statute does not apply in terms the "method of accounting * * * in keeping the books" which it approves, will be just as appropriate wherever similar facts are to be dealt with. (See *Gooch v. Oregon Short Line R. R. Co.*, infra, page 57.) The figures we are dealing with are a percentage of the fire insurance company's figures. The analogy is mathematically perfect.

(c) The second method of return urged by petitioner was suggested by an Act of Congress. In 1921 Congress determined that in the case of fire insurance companies it would be more accurate to have premium income returned on a pro rata basis, returning the income actually earned within the year. Accordingly, by §246 of the Revenue Act of 1921, it was provided that companies other than mutual and life should make return on the following basis: Return as gross income

> "The combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;
>
> " * * *
>
> "The term 'underwriting income' means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;
>
> "The term 'premiums earned on insurance contracts during the taxable year' means an amount computed as follows:
>
> "From the amount of gross premiums written on insurance contracts during the taxable year deduct return premiums and premiums paid for reinsurance. To the result obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year."

This statute was carried into the later acts. See 26 U. S. C., §1006 (Revenue Act of 1924 and 1926, §246, 43 Stat. 290,

and 44 Stat. 48), 26 U. S. C., §2204 (Revenue Act of 1928, §204, 45 Stat. 844), 26 U. S. C., §3204 (Revenue Act of 1932, §204, 47 Stat. 225).

These statutes in terms apply only to insurance companies, not to general agencies. This is not conclusive, "for, * * *, it is obvious that a statute may indicate a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. *Johnson v. United States,* 163 Fed. 30, 32, 98 C. C. A. 508, 18 L. R. A. (N. S.) 1194." (*Gooch v. Oregon Short Line R. R. Co.,* 258 U. S. 22, 24, 66 L. ed. 443, 445. *Acc., South & Central Am. C. Co. v. Panama R. Co.,* 237 N. Y. 287, 142 N. E. 666, 667.)

Again, Congress created nothing. The Act merely sanctioned the use, for income tax purposes, of established accounting practice—a general practice of accounting by no means confined to insurance companies.

Kester Accounting—Theory and Practice (Appendix E, page xi et seq.);

Esquerre, Applied Theory of Accounts, (Appendix E, page xxvii);

Wiegand, Fire Insurance Accounting, (Appendix E, page xliv);

Montgomery, Federal Tax Handbook, (Appendix E, page xxx);

Knight, Bookkeeping (Appendix E, page xxv);

Accounting Terminology (Appendix E, page xxxvi);

Finney, Principles of Accounting, (Appendix E, page xxxvi);

Lough, Business Finance (Appendix E, page xxxvii).

The petitioner on this basis proved the actual earned income for each year in question. This was done by prorating the commission over the life of the various policies. This work was done by Mr. Logan. He testified that he was familiar with the underwriting and investment exhibits of the annual statement approved by the National Convention of Insurance Commissioners (see statute quoted above, page 56), with the method used on these reports for prorating premiums, and that he had used the same method. (R. 199.) This method is to average the policies written for a year by assuming them to be written at the middle of the year, and prorating the premium. Thus one-half of the premium (and commission) of all one year policies written within a year, will be earned that year, and the other half the next year. As to three year policies earnings are segregated on this basis one-sixth to the first year, one-third to the second year, one-third to the third year, and one-sixth to the fourth year. (This is explained in detail in the record, at pages 199-201. See, also, Wiegand, Fire Insurance Accounting, Appendix E, page xliv; Cf. Hebert at page xxxix.) The exhibits showing the results are petitioner's Exhibits 20, 21, 22, 23, 24, and 27. These show the computations on two theories—(1) on the theory that the petitioner must show all insurance written by Edward Brown & Sons and in force in 1923 and later, going back to 1918 for five year policies, and, (2) on the theory, that in order to pick up earnings in 1923 and later years petitioner need go back only to the time when he became sole proprietor of the business, which was when his brother died, August 1, 1922. The accuracy of these figures has never been questioned.

It is believed that this second method, approved by Congress, is the more accurate of the two; that it more nearly accords with the accrual method of keeping accounts, and that since petitioner's tax has been opened for redetermination this method should be used.

(d) If the method upon which the return was made is to be used, we cannot, of course, deduct for 1923 both a reserve against cancellation in later years and the return actually made in 1923. To apply the system correctly it would be necessary to set up a reserve as of December 31, 1922 and charge cancellations of business written before that date against that reserve. The figures to this end were proved and appropriate computations made. (R. 239-245; Exhibits 29 and 30.) We anticipated the argument that we would be claiming double deductions. The appropriate calculations to meet it have been made.

If the strict actuarial method is to be used, then we must account for all commissions earned, and to do this must pick up figures for business written before, but in force in, the years in question. It is submitted that in doing this we need not go back to 1918, but are required only to pick up the commission on policies written while petitioner was the sole proprietor of the business, and thereafter. The death of Herbert Brown dissolved the partnership existing between him and petitioner. (*Cal. Civ. Cod.*, §2450, as it existed in 1922, expressly provided that "a general partnership is dissolved as to all the partners * * * by the death of a partner." 47 *C. J.*, 1040.) The business which petitioner conducted after his brother's death was something new—it was not the partnership business. His title

to the assets of *that* business was a new and different title. He had no title to any of the partnership assets. He had only a right in any net which might remain on dissolution or on an accounting.

47 *C. J.*, 780;
Buckley v. Carlisle, 2 Cal. 420;
Chase v. Steel, 9 Cal. 64;
Driscoll v. Driscoll, 143 Cal. 528;
Fong Sing v. O'Dell, 50 Cal. App. 55.

On dissolution of the partnership the only power over its assets, which the petitioner had, was the power of liquidation. (47 *C. J.*, 1040; *Cal. Civ. Cod.*, 1922, §§2458-2462; *Cal. Cod. Civ. Proc.*, 1922 §1585.)

To go back only to August, 1922, will not deprive the Government of any tax. The tax on all commission shown on the old partnership books was paid to the Government under the old basis of return, when Herbert Brown and petitioner made their returns as partners and individuals for 1918-1922. This consideration is pointed out simply to prevent again income taxing upon which the Government has already collected its toll.

Criticisms of Suggested Methods of Return.

Against these considerations and authorities, it is first suggested by the court below that the taxpayer should account for income in the year in which he received it and not at some indefinite future time of his own selection. If it is meant that income received must be returned, without deduction for liabilities concurrently incurred although not yet paid, the statement, we say with deference, is in-

accurate and in conflict with the decisions of this court, where the books are kept on the accrual basis. The implication that the petitioner here is seeking to return his income "at some indefinite future time of his own selection," is unwarranted. Whether the return be made by returning income received less a reserve, or be returned on a strict pro rata and actuarial basis, as earned, the income will not be returned at some future and indefinite time, but the time and amount of return is definitely fixed by the life of the insurance policies to which the commission relates. *The time and method selected by the petitioner, far from being indefinite and of his own selection, are the exact methods which Congress prescribed for fire insurance companies.*

Next, the opinion states that the methods urged will make the collection of revenue uncertain, and make the Government gamble on the continued solvency of the taxpayer. To this there are two answers. If this is true, it is a consideration which should be urged on Congress. If there is such a risk, it is one which the Government has been willing to take, to date. The risk is expressly taken with insurance companies. It is impliedly taken in every case, for taxpayers are permitted themselves to assess the tax in the first instance. It is common knowledge that it is sometimes a matter of years before returns are audited, litigated, and the final tax fixed and paid. But the real answer is that there is no such risk. If a proper method of return shows that the Government is entitled, in a particular year, to only a given amount as tax, that in itself is a complete answer. If, in arriving at the amount of the income to be taxed, allowance is made for obligations

owed to third persons, and if the taxpayer cannot meet those obligations in the future, the loss is not that of the Government but of the obligees.

Finally, it is said that reserves to cover contingent liabilities are not allowed as deductions unless sanctioned by statute. The cases upon which we rely, as indicating that such a reserve as was sought to be set up here is properly allowable, have already been noticed. It remains only to say that an analysis of the cases cited will not support the holding of the court here.

Three of the cases cited and relied upon were cases of attempts to deduct an amount as a "reserve" against a single isolated and *disputed* claim. This reserve was attempted to be set up in advance of determination of either liability itself or the amount of any liability.

Lucas v. American Code Co., 280 U. S. 445, 74 L. ed. 538;

Consolidated T. Co. v. Bowers, 19 F. (2d) 382 (D. C.);

Lane Construction Corp., 17 B. T. A. 826, 49 F. (2d) 1080 (C. C. A. 2).

The *Lucas Case* is expressly distinguished in *Virginia-Lincoln Furniture Co. v. Commissioner*, supra. The "reserve" in the *Lucas Case* had no relation to any anticipated liability. See pages 49-50 above.

Spring Canyon Coal Co. v. Commissioner, 43 F. (2d) 78 (C. C. A. 10) was an attempt to deduct a so-called "reserve" to meet possible liability on tort claims, where the facts—the accidents—upon which such claims might be predicated, had not yet occurred.

Highland Milk Condensing Co. v. Phillips, 34 F. (2d) 777 (C. C. A. 3), was an attempt to deduct repayments made to buyers of merchandise to protect them against a declining market. There was no past experience for such a deduction, either as to amount, time, or necessity. It was a single, isolated, and unusual matter.

Earle v. Commissioner, 38 F. (2d) 965 (C. C. A. 1), did not involve any question of deductions for liabilities, contingent or otherwise, but presented a question as to the proper method of return of a partner's distributive share under Rev. Act. 1921 §218 upon dissolution of the partnership by death. The general statement made that income for one year cannot be wiped out by losses of another year is correct as a general statement, of course.

William J. Ostheimer, 1 B. T. A. 18, has little to recommend it, and is believed out of harmony with the views of this court. (Compare particularly *Gambrinus Brewery Co. v. Anderson*, 282 U. S. 638, 75 L. ed. 588.) Be that as it may, the case has no analogy here. There a reserve to meet a possible liability to return leased chattels in as good condition as when they were let, was set up because the lessee was faced with the impossibility of the renewal of the lease due to national prohibition. No basis for the "reserve" was shown. One member of the Board dissented.

Thomas Cronin Co. v. Lewellyn, 9 F. (2d) 974 (D. C.) and *Uvalde Co.*, 1 B. T. A. 932, involved street paving contracts. The contractor was paid at the completion of his work. According to his contract he was required to repair any defects which might appear within a stated length

of time. He set up a fund to meet the anticipated expenses. It was held that this was not a proper deduction. The amounts were apparently based on pure guess, and it was found that it was impossible on any basis to determine the amount necessary to be deducted. In addition, it is to be noticed, that if the contract were properly performed in the first instance, there would be no defects and no expense of repair. This is pointed out in the *Thomas Cronin Co. Case*. These cases have been severely commented on by text writers. See *Montgomery, Income Tax Procedure*, 1927 Ed. 239, 241, 244, 265 and 268; *Montgomery, Federal Tax Handbook*, p. 19 et seq.; *Klein, Federal Income Tax*, 137 (quoted with approval in *Virginia-Lincoln Furniture Corp. v. Commissioner*, supra), stating that "it is unthinkable that a higher tribunal, or the Board itself, will not change the situation sooner or later."

The other two authorities cited are *Jackson Casket & Mfg. Co.*, 7 B. T. A. 1190, and *Landesman-Hirschheimer Co.*, 15 B. T. A. 604. These are discount cases—customers were permitted a discount on performance of certain conditions. A reserve was set up to meet this discount. This reserve was disallowed. But this line of cases did not stop here. It was continued, and the rule of these cases followed in the *Virginia Table Case*, another discount case. This case was appealed to the Circuit Court of Appeals for the Fourth Circuit as *Virginia-Lincoln Furniture Corp. v. Commissioner*, 56 F. (2d) 1028, to which reference has been made several times. The court reversed the Board of Tax Appeals, and expressly disapproved this line of cases in the Board. The order in the *Landesman-Hirschheimer Co. Case* was affirmed on appeal, but this was solely upon the

ground that the record was incomplete (44 F. (2d) 521—C. C. A. 6.) The Circuit Court of Appeals, in the course of its opinion said:

> "*But the income tax laws are predicated upon the assumption of a true valuation of both tangible property and choses in action.* It follows that, where a reserve is created to take care of depreciation or obsolescence, or to provide for that portion of accounts receivable which, in all probability, will never be collected, the function of such reserve is not to provide for contemplated capital expenditure, but rather to prevent an unwarranted increase in surplus, *by limiting the particular asset item to its true value.* In the case of accounts receivable, such purpose is to show the probable, true, present value of the accounts, or that sum which it is expected will be realized from such accounts. This is an income item, and the amount of discounts actually taken during the current year, is properly handled in the profit and loss statement for that year or by a deduction from current income, figuring the amount of such income as the sum of the undiscounted items, deducting the discounts and thus arriving at the actual or true income. These probable future deductions from income can in no true sense be said to be capital embarked by the stockholders in the enterprise, or earned therein, for, if the discount be taken, it will not have been earned. *The real situation could better be shown by deducting the amount of the reserve from the total of the accounts receivable, on the asset side of the statement, and thus fixing the valuation of accounts receivable at that sum which is probably collectible thereon.*"

In the concurring opinion it is first suggested that we are not entitled to deduct a reserve, and also the premiums actually returned. This is conceded, and the exhibits put into the record, by the petitioner show adjustments to prevent duplicate deduction (see page 59 above and *Virginia-Lincoln Furniture Corp. v. Commissioner,* handling a similar situation). It is also said that if the deductions sought to be taken are reasonable, it will make no difference in the long run how the returns are made—whether on the basis insisted upon by respondent, or on the basis insisted upon by petitioner. It is believed that this suggestion falls into error in two respects. In the first place, it is necessary to allocate income properly to the various years because of the tax rates. They vary from year to year, and are graduated according to amount of income. In the second place, "income taxes are levied upon the net income for an annual accounting period. Gains in one period may not be offset by losses in another" (*Earle v. Commissioner,* supra; cases at page 33 above). And if the suggestion is correct it cuts both ways—it applies equally to the Government. It indicates that the method we suggest will not unduly prejudice the Government, and correctly reflect true income.

CONCLUSION.

It is respectfully submitted, that the judgment of the Circuit Court of Appeals and the decisions of the Board of Tax Appeals should be reversed, and that petitioner's tax for the years in question should be assessed on the strict actuarial basis, or if not, then on the basis used by

him in making his return. The figures have not been discussed in detail, because this court will not consider matters which were not considered below. (*Burnet v. Commonwealth Imp. Co.*, 287 U. S. 415, 77 L. ed. 249—Oct. Term 1932, No. 95.)

The matter of accounting in such a way as to make each annual period complete within itself, and accurate, has more than theoretic interest. Enough appears to show that the matter is one of practical importance, both to petitioner and the Government. Even if we assume no change in tax rate from year to year and no net loss for any given year, this is still true. Experience shows that cancellations are a constant percentage of business written. If much business was written for 1923, and little for 1922 and 1924, it will decidedly distort income if the small cancellations of 1922 business are deducted from 1923, and the large cancellations of 1923 business are deducted from a small year, 1924. If income is not to be distorted it must be returned either as earned, or, each year must have charged to it the cancellations which are attributable to its business.

Dated at San Francisco, California, November 7, 1933.

LLOYD M. ROBBINS,
Counsel for Petitioner.

ARTHUR B. DUNNE,
Of Counsel.

(APPENDIX FOLLOWS.)

APPENDIX A.

TREASURY REGULATIONS.

The regulations quoted are Regulations 62, relating to the Revenue Act of 1921; 65, relating to the Revenue Act of 1924; and 69, relating to the Revenue Act of 1926. In each instance corresponding articles of Regulations 74 and 77, relating to the Revenue Acts of 1928 and 1932 are given. Quotations are taken from Regulation 62 unless otherwise noted. In some few instances there are verbal changes, but these are not noticed unless they change the meaning.

"Art. 21. **Meaning of net income.**—The tax imposed by the statute is upon income. In the computation of the tax various classes of income must be considered: (a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. *Income can not be determined merely by reckoning cash receipts, for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property, exhaustion, and accounts payable for expenses incurred.* See sections 202, 203, 206, 213, and 214 of the statute. (b) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by the statute. See section 213 and articles 71-91. (c) Net income, mean-

ing gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. See sections 214 and 215 and the articles thereunder. (d) Net income less credits. See section 216 and articles 301-306. The surtax is imposed upon net income; the normal tax upon net income less credits. *Though taxable net income is a statutory conception it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory 'net income' is commercial 'net income'. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer.* As to the net income of corporations see section 232 and article 531."

(Regs. 74 & 77, Art. 41.)

"Art. 22. **Computation of net income.**—Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year. *Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money.* The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income.

If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. See article 51. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

(Regs. 74 & 77, Art. 321.)

"Art. 23. **Bases of computation.**—(1) *Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of 'paid', 'paid or accrued', and 'paid or incurred'. All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period.* See section 213 (a). For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. See article 53. On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer

prior to the realization of such appreciation through sale or conversion of the property. But see section 203.

"* * *"

(Regs. 74 & 77, Art. 322.)

"Art. 24. **Methods of accounting.**—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, *and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose.* Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. See section 1300 of the statute and article 1711. Among the essentials are the following:

"(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see arts, 1581-1588);

"(2) Expenditures made during the year should be properly classified as between capital and income, that is to say, that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

"(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear,

depletion, or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. But see article 222."

(Regs. 74 & 77, Art. 323.)

"Art. 36. **Long-term contracts.**—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon the following bases:

"(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. * * *.

"(b) * * *

"Where a taxpayer has filed his return in accordance with the method of accounting regularly employed by him in keeping his books and such method clearly reflects the income, he will not be required to change to either of the methods above set forth. * * *."

(Regs. 74 & 77, Art. 334.)

"Art. 51. (Regs. 65 & 69, Art. 50.) **When included in gross income.**—Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer,

unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. See articles 21-24; as to dividends, see section 201 (e) and articles 1541-1549. A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. See articles 111 and 151. Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined."

(Regs. 74 & 77, Art. 331.)

"Art. 91. **Subtraction for redemption of trading stamps.**—Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light

of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing (a) the total issue of stamps during each year, (b) the total stamps redeemed in each year, and (c) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required."

(Regs. 74 & 77, Art. 335.)

"Art. 111. (Regs. 65 & 69, Art. 112.) **When charges deductible.** — Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21-24 and 51. *The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year.* But see section 204 and articles 1601-1605. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest,

taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained. But see article 146. See section 252 of the statute and articles 1031-1038; see also section 214 (a) (6)."

(Regs. 74 & 77, Art. 342.)

"Art. 151. **Bad debts.**—Bad debts may be treated in either of two ways—(1) by a deduction from income in respect of debts ascertained to be worthless in whole or in part, or (2) by a deduction from income of an addition to a reserve for bad debts. * * *"

(Regs. 74 & 77, Art. 191.)

"Art. 155. **Reserve for bad debts.**—Taxpayers who have, prior to 1921, maintained reserve accounts for bad debts may deduct a reasonable addition to such reserves in lieu of a deduction for specific bad-debt items. * * * What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. * * *"

(Regs. 74 & 77, Art. 195.)

(Reg. 62.) "Art. 1533. * * * 'Paid' is to be construed in each instance in the light of the method used in computing net income, whether on an accrual or a receipts basis. See article 23."

(Regs. 65 & 69) "Art. 1523. The taxable year is the time unit for the purpose of the tax. * * * The terms 'paid or incurred' and 'paid or accrued' will be construed *according to the method of accounting upon the basis of which net income is computed by the taxpayer.* The deductions and credits provided for in this title must be taken for the taxable year in which 'paid or accrued', or 'paid or incurred', unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. * * *"

(Regs. 74 & 77, Art. 341.)

APPENDIX B.

The Treasury Department, pursuant to Section 13(d) of Part II of the Act of 1916, issued Treasury Decision 2433 as follows (Treasury Decisions, Vol. 19, p. 5):

"Corporations keeping books in accordance with standard systems of accounting or in conformity with the requirements of some Federal, State, or municipal authority having supervision over such corporations, may make their returns on the basis on which their books are kept, provided the books so kept and the returns so made reflect the true net income of the corporations for each year. (Syllabus.)

"Treasury Department,
"Office of Commissioner
"of Internal Revenue,
"Washington, D. C., January 8, 1917.

"To collectors of Internal Revenue:

"Subparagraph (d) of Section 13, of Title I of the act of September 8, 1916, provides that—

"'A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.'

"Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

"In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; and provided, if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs

for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

"This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

"If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon any basis other than that of actual receipts and disbursements.

"The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts,

capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

"W. H. OSBORN,
"Commissioner of Internal Revenue.

"Approved:

"W. G. McADOO,
"Secretary of the Treasury."

Approved, quoted and cited in:

U. S. v. Anderson, 260 U. S. 422, 70 L. ed. 347;
American National Co. v. U. S., 274 U. S. 99, 101, 71 L. ed. 946, 947;
Niles Bement Pond Co. v. U. S., 281 U. S. 357, 359, 74 L. ed. 901, 903;
Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 75 L. ed. 234.

APPENDIX C.

Idaho, Compiled Statutes § 5009, Statutes of 1915, Chapter 145, §2, p. 318, R. 167:

"Foreign Companies Except Life Must Have Resident Agents. It shall be unlawful for any foreign insurance company doing business in this state to make, write, place or cause to be made, written or placed in this state any policy, * * * unless done through an agent who is a resident of this state, legally commissioned and licensed to transact insurance business herein. A resident agent shall countersign all policies so issued (except policies of life insurance) and shall receive the full commission when the premium is paid * * *."

California Political Code, § 633d:

* * * * * * *

"Agent in state to approve risks, countersign policies, etc. No insurance company or other insurer, authorized to transact business in this state, shall make, write, place or cause to be made, written or placed, any policy * * * except through, or after a risk has been approved in writing by, an agent of the company residing in this state and regularly authorized to transact such business therein, who shall countersign all such policies * * * and receive or be credited with the premium thereon when paid, and who shall also receive any commission paid or allowed on such premium * * *."

Province of British Columbia, Insurance Act, Acts of 1925, Chapter 20; 1926-1927, Chapter 35; 1928, Chapter 19, consolidated as the Insurance Act, August 17, 1928, §§ 149, 160, 183-186, 197. Sections 149 and 160 provide:

"In this section the expression 'agent' means an insurance agent licensed under this Act * * * and whose compensation or profit therefor consists wholly of a commission on premiums derived from such business * * *."

"No licensed insurer shall issue any policy unless the policy is signed or countersigned by an agent, but no agent shall sign a policy in blank or in otherwise incomplete condition."

* * * * * * *

Sections 183-186 contain detailed provisions for licensing of agents.

* * * * * * *

"197. (1) No insurer, no officer, agent, or employee of an insurer, and no insurance agent licensed under this Part shall, directly or indirectly, pay or allow, or offer or agree to pay or allow, any commission or other compensation or thing of value to any person for acting or attempting or assuming to act as an insurance agent in respect of insurance on life or property in the Province, unless that person holds at the time an insurance agent's license under this Part; and every insurer or other person who violates any provision of this section, or who knowingly receives any commission, compensation, or thing of value paid or allowed in violation of this section, shall be guilty of an offence against this Act."

* * * * * * *

Nevada Revised Laws, § 1304, as amended by Statutes 1919, 392:

"It shall be unlawful for any insurance company admitted to do business in this state to write, place, or cause to be written or placed, any policy of insurance covering property located in this State except through or by a duly authorized licensed agent of such company, residing and doing business in this State; *provided,* that where the insured calls at the principal office of the company and requests a policy, the risk may be covered, and the policy procured through the duly authorized agent in the territory wherein the risk is located; *and provided further,* that a nonresident special agent, representing a company licensed by this State may work with and assist local agents in this State in writing business, but in all cases the local agent is to retain his full commission * * *."

Montana Code, § 6118, Insurance Laws of the State of Montana, Compiled by Insurance Department, 1929, p. 29:

"Before transacting any fire, life, or other indemnity or insurance business, each and every agent, firm, or corporation acting as agent, solicitor, or representative of such corporations or associations, shall procure annually from the state auditor a certificate of authority or license as an agent, solicitor, or representative of each corporation or association represented by him or them * * * provided, that the state auditor is hereby prohibited from issuing a certificate of authority to write policies of insurance, or to solicit and obtain and transact

insurance business as defined in this act, to any person, agent, firm or corporation, unless such person, agent, firm, or corporation is a legal resident of the state of Montana at the time such certificate of authority is issued. * * *"

Wyoming, Insurance Laws, § 11, Laws 1921, Chapter 142, § 3:

"It shall be unlawful for any insurance company, other than life, admitted to do business in this state, to write, place, or cause to be written or placed, any contract or policy of insurance covering risks located in this state, except through or by a duly authorized licensed agent of such company residing and doing business in this state; * * * provided, further, that a license may be granted to a non-resident general agent or special agent authorizing such agent to work with and assist local agents in this state, in writing business, but in all cases, the local agent is to retain his full commissions."

* * * * * * *

Oregon, Insurance Laws, § 4, Olson, Oregon Laws, § 6333, Laws 1923, Chapter 115, § 1, p. 172:

"No company * * * authorized to transact insurance * * * and not incorporated under the laws of this state, * * * shall make, write, place or cause to be made, written or placed, any policy * * * except through their regularly commissioned and licensed resident agents, who

shall countersign all policies * * * and collect the premiums therefor * * *.

* * * * * * *

"Every company duly authorized and licensed to transact insurance business * * * in the State of Oregon * * * may in respect thereof appoint an agent or agents in each city, town or village in this state, and the name of every agent appointed in accordance with the provisions of this section * * * shall be filed with the insurance commissioner * * *. The insurance commissioner, if he finds the agent qualified, shall thereupon issue to each such agent a license * * *.

* * * * * * *

"It shall be unlawful for any person * * * to write, place, procure or cause to be written, placed or procured any policy * * * except through and by a legally authorized and licensed resident agent in this state * * *."

APPENDIX D.

Bulletin issued by Federal Reserve Board entitled, "Verification of Financial Statements—Revised May, 1929", published by United States Government Printing Office, Washington, 1929.

The title page of this publication is as follows:

"VERIFICATION OF
FINANCIAL STATEMENTS
(Revised)
A METHOD OF PROCEDURE
Submitted By
THE FEDERAL RESERVE BOARD
Washington
FOR THE CONSIDERATION OF
BANKERS, MERCHANTS, MANUFACTURERS
AUDITORS, AND ACCOUNTANTS

"A revision, by the American Institute of Accountants, of suggestions for the preparation of balance-sheet statements printed in the April, 1917, issue of the Federal Reserve Bulletin and reprinted in pamphlet form in 1918 for general distribution under the title 'Approved Methods for the Preparation of Balance-Sheet Statements.'"

The bulletin contains the following:

"PREFACE

"The following suggestions for the verification and preparation of balance sheets and profit-and-loss statements are a revision of suggestions which appeared in the April, 1917, issue of the Federal Reserve Bulletin and

were reprinted for general distribution in 1918 under the title Approved Methods for the Preparation of Balance-Sheet Statements.

"The first edition was issued with the intention of standardizing the forms of statements submitted to bankers for credit purposes, and it provided a program for verification of items and uniform compilation of statements.

. . . . . .

"As a first step toward standardization the Federal Trade Commission in 1917 requested the American Institute of Accountants to prepare a memorandum on procedure. A memorandum was prepared and approved by the council of the Institute. After approval by the Federal Trade Commission the memorandum was placed before the Federal Reserve Board for consideration. The Federal Reserve Board, after conferences with representatives of the Federal Trade Commission and of the American Institute of Accountants, accepted the memorandum, gave it tentative indorsement, and submitted it to bankers and banking associations throughout the country for their consideration and criticism. The memorandum was subsequently published in pamphlet form and was reprinted several times.

"The recommendations in the memorandum have been on trial more than 10 years, and various criticisms and suggestions for minor changes have been made. Some professional accountants regard the original program of procedure as more comprehensive than their conception of a so-called balance-sheet audit but not more than is

required in the preparation of statements to be submitted by persons or companies seeking credit or loans of cash. Some accountants have felt that all the instructions were not as clear as they might be. Others have said that the procedure would not bring out all the desired information. The suggested form of certifictae did not, perhaps, make it plain that the examination was not a complete audit of the accounts, and it was to that extent misleading.

"After consideration of the desirability of a revision of the bulletin the American Institute of Accountants appointed a special committee to deal with this and certain other matters. *The result of the labors of that committee is submitted in this revised edition, which represents what the Institute believes to be the best modern practice of the profession.*"

The bulletin begins the general instructions as follows:

"GENERAL INSTRUCTIONS

"The scope of the work indicated in these instructions includes a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit-and-loss account for the period under review, and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check. The procedure described is designed for the auditor's use primarily in the case of industrial and mercantile concerns, but it is also applicable in the case of most other business enterprises."

Then comes specific instructions for handling particular items. The instructions make it clear that it is intended that these various items shall be handled in such a way that there shall be shown their true present value, charging against the various items, to show the true present value, such outgo as there is likely to be in the future, and which will be referable to and reducing the present value of these items.

Under Notes Receivable, where notes have been discounted, it is stated that the company has a contingent liability which should be shown. (Instr. 19.)

Under Accounts Receivable, it is stated that if trade discounts and freight allowed have been included in accounts receivable, "an appropriate reserve should be set up". (Instr. 28.)

Under Inventories, "if goods consigned to others are included, they must be carried at cost prices, less a proper allowance for loss, damage, or expenses of possible subsequent return". (Instr. 55 (h).) Price lists are to be checked to see that cost prices are below net selling prices, and "if they are not lower an adequate reserve should be set up on the balance sheet". (Instr. 55(q).)

Under Inventories, the following instruction is given:

"The selling prices for contract work in progress should be ascertained from the contracts, and, if it is apparent that there will be a loss on the completed contract, a due proportion of the estimated loss should be charged to the period under audit by setting up a reserve for losses on contracts in progress." (Instr. 55 (s).)

Under Fixed Property, the following instructions appear:

"The auditor should ascertain whether or not any installments are due on account of construction work in progress which is being carried on by outside parties; if so, the liabilities for these installments should be included on the balance sheet, as they may have a direct bearing on the amount of available cash on hand." (Instr. 57(g).)

"The auditor should satisfy himself that the reserves for depreciation of buildings, machinery, equipment, etc., are sufficient to meet the deterioration in value of fixed properties. If in his opinion the reserves shown on the balance sheet are insufficient he should refer to the fact in his certificate." (Instr. 57 (i).)

Under Deferred Charges to Operations, the following appears:

"Unexpired insurance, bond discounts applicable to a future period, prepaid royalties, experimental charges, etc., are grouped in the balance sheet under the heading, 'Deferred Charges.' After the clerical accuracy of the deferred charges has been verified, the auditor should satisfy himself that they are properly carried forward to account of future operations." (Instr. 60.)

Under Accounts Payable, the following appears:

"Where a modern voucher system is not in operation, the auditor must exercise particular care to satisfy himself that all liabilities are included in the accounts, for example:

"(a) Payments shown by the cashbook to have been made subsequent to the date of the balance sheet should be analyzed to ascertain whether any of them are applicable or not to the period under review." (Instr. 73.)

Under Contingent Liabilities, it is said:

"*It is not enough that a balance sheet show what must be paid—it should set forth with as much particularity as possible what may have to be paid.* It is the duty of an auditor to discover and report upon liabilities of every description, not only definitely ascertained debts but possible debts. * * *" (Instr. 78.)

Then follow special instructions for handling endorsements, guaranties, unfulfilled contracts, taxes, damages, and liabilities on bonds and mortgages. As to taxes and damages it is said:

"The possibility of unsettled Federal and other taxes for prior years should be investigated to determine whether or not there may be a liability for which provision has not been made." (Instr. 82.)

"There may be claims or suits for damages not covered by insurance, and where the auditor finds any evidence which leads him to suspect the existence of a liability of this nature he should demand full information. He can then form an opinion as to the amount which should be set up as a contingent liability or, if the outcome is uncertain, as a reserve against possible loss." (Instr. 83.)

Under Accrued Liabilities, the general instruction is as follows:

"Interest, taxes, wages, etc., which have accrued to the end of the period under review, but are not due and pay-

able until a later date, are grouped on the balance sheet under the heading, 'accrued liabilities.' These items can be accurately verified by the books and records." (Instr. 85.)

Special attention is then directed to interest payable, taxes, with appropriate "reserve for accrued taxes" (Instr. 88), salaries, expenses, etc. Under traveling expenses and commissions, the following appears:

"Ample allowance should be made for all commissions eventually payable on sales which have been charged to customers. As commissions frequently are not payable to salesmen until payment has been received from customers, accrued commissions are often omitted from the books. They must, however, be paid out of the proceeds of the sales whose full profit has already been taken into the accounts, and they should be set up as an accrued liability." (Instr. 93.)

In immediate sequence are the following instructions:

"*Legal Expenses.*—Provision should be made for any accrued liability for legal expenses not already on the books." (Instr. 94.)

"*Damages.*—If the concern is insured against liability for damages to employees or the public, a proportion of the premiums paid in advance for the unexpired time covered by the insurance will appear in 'deferred charges.' But there may be claims or suits for damages not covered by insurance, and if the auditor finds any evidence which leads him to suspect a liability of this nature he should insist upon full information. He can then form an opinion as to the amount that should be

set up as an accrued liability or, if the outcome is uncertain, as a reserve against possible loss. The auditor should consider the adequacy or inadequacy of the accrued liability for premiums on insurance carried to cover compensation for injury to employees." (Instr. 95.)

Under the instructions for getting up profit and loss statements, the following appears:

"Allowances to customers for trade discounts, outward freights, reductions in price, etc., should be deducted from gross sales in the profit-and-loss statement." (Instr. 118.)

APPENDIX E.

Esquerre, Applied Theory of Accounts, pp. 299-301, has the following to say relative to the cash basis and the accrual basis:

The Cash Basis.—It may be that the policy of a concern is to keep its books on the "cash basis;" that is to say, to consider as income earned only that which has been received in cash, and that, correspondingly, only expenses paid in cash constitute income disbursed. This policy has the great disadvantage of not being consistent. It rests upon the possibility that the right to receive income may be lost by the failure of the debtor to pay what he owes, and upon the impossibility of enforcing payment when such contingency occurs. But if the basis is correct, it should apply also to accounts receivable recorded as a result of sales on credit, since the amount charged to customers contains not only the cost of the goods sold to them, but, as well, the profit realized on the sales. It is obvious that if it is sound theory to ignore income until it is received it is also sound theory to ignore the profit on sales until the customers have paid the indebtedness which contains those profits. Yet it is doubtful whether a single instance could be found where a business concern which claims to be on a cash basis is consistent enough to apply that basis to merchandise transactions.

The Accrual Basis.—Many concerns keep their books on the "accrual basis." This method applies the accounting principle that the primary connection between the

net assets and the net income derived therefrom, is a matter of earnings and of expense incurred, and not one of income received in cash and expenses paid in cash. It takes cognizance of the fact that unless income is recorded when earned, losses due to the failure to collect that income can not appear on financial statements.

* * * * * * *

Leaving expenses and liabilities out of the question for the time being, the adoption of the accrual basis means that, at the end of every accounting period, all income which has been earned during that period must be recorded as an accrued asset which, while perhaps not collected at the time, because it is not due, may be collected at some future time. This, of course, necessitates the recording of an income which will be credited to the profit and loss of the period, whether or not the accrued asset which it represents fails of collection. Thus, if the last interest receivable on investments in bonds of other companies or in bonds and mortgages or in loans on collateral, was received December 1, and the accounting period ends December 31, there has been earned interest for one month, which is an asset of the investor, as well as it is his income for the month of December.

(The foregoing is quoted with approval in Appendix B of the brief of Honorable William D. Mitchell, Solicitor General, in *United States v. Anderson,* 269 U. S. 422, 70 L. ed. 347.)

In Montgomery, Auditing Theory and Practice (3rd Ed.) Vol. 1, pp. 495, 496, we find the following discussion:

The Accrual Method: To be correct the income account for a given period must contain all of the earnings or revenue and all the expenses or costs applicable to that period. All transactions during the current period which apply to a previous period should have been included in that period, and all transactions which belong to the succeeding period or periods must be deferred. In the former case, if proper reserves were set up for the items, no adjustment is necessary in the current period. * * *

It is hardly possible that an accurate balance sheet or income account of any business can be prepared unless the accrual basis is adopted. Concerns which close their books immediately after the end of a fiscal period almost always fail to include some items which belong to that period. *In practically all cases the omitted items are expenses, rather than earnings, so that the errors due to omission usually unduly increase the net income.* It is therefore important for an auditor to advise that books be left open long enough to ascertain the amount of liabilities which have been incurred but not discharged at the closing date.

(The foregoing is quoted with approval in Appendix B of the brief of Honorable William D. Mitchell, Solicitor General, in *United States v. Anderson*, 269 U. S. 422, 70 L. ed. 347.)

Montgomery, Federal Tax Handbook, October 1932:

(p. 7) "*The two methods of computing net income most widely used are the 'cash basis' and the 'accrual basis', both of which are officially recognized by the Treasury.* * * * One or another of the methods of accounting referred to in the preceding paragraph is suitable to the great majority of taxpayers. * * * If the method used correctly reflects net income, it should be approved, regardless of its label, and taxpayers should appeal to the Board, or the courts if necessary, before submitting to tax on net income not correctly determined."

(pp. 8 and 9) "Although it is probable that a majority of taxpayers report on the cash basis, it is seldom that true net income can be determined on this basis. For most taxpayers, not engaged in business, whose income consists mainly of salaries, bond interest, or dividends, the use of the cash basis is justified on the ground of simplicity, even if the accrual basis more accurately reflects net income. For taxpayers engaged in business, the accrual basis is preferable, and where the use of inventories is an income-producing factor, the accrual basis is required by the Treasury. (Art. 322, Reg. 74.)

"*The only known method of applying all expenses, costs, and charges to the gross income which arises from the use of the charges is to record the costs in the period in which they belong. This is known as the accrual method.*

"*Under the accrual method everything which belongs in an accounting period is thrown into that period. Con-*

versely, every transaction in one period which affects the income of an earlier or later period is thrown out.

* * * * * * *

"Both the cash and accrual methods have been held by the Board and the courts to reflect taxable income accurately. The test is: *Does* the method used comply with the law which clearly imposes a tax on all income on an annual basis? Minor items can be disregarded if the method *adopted* and *consistently* followed substantially complies with the law."

(p. 10) "It follows very logically that the only measurement which is of any value for comparative purposes is a translation of day-by-day transactions into the net income which is derived therefrom. What is called the accrual method must be used to the fullest extent, and the danger of mistakes of fact and mistakes of judgment must be faced or net income will be incapable of determination with reasonable accuracy, either for the taxpayer's use and guidance or for the government to tax."

(p. 13) "The attitude of the Treasury and the Board is becoming increasingly illogical with respect to what constitutes the accrual method of accounting. They sometimes apply the rule properly in the case of expenses and in the case of income unrealized in cash at the end of the accounting period, but where fees or other income are collected in advance they insist on taxing such income in the year in which it is collected."

(pp. 14 and 15) "What Is Meaning of 'Accrual'.—The rulings and decisions of the Treasury and Board dealing with accruals and the accrual method of account-

ing are loaded with inconsistencies. *The fault has been not so much with the formal regulations as with their administration. When items of income arise or are collected in one period, and part of the income belongs to another period, good accounting practice requires that reserves be set up so that the first period will not have the benefit of unrealized income.* To treat such items as fees and dues paid in advance as income when received by taxpayers on the accrual basis is a mistaken position. The same mistaken attitude is evident in the treatment of certain deferred expenses such as expenses for advertising in one period to stimulate sales of the following period. The trouble seems to arise from the confusion of 'accrued' with 'due and receivable' and 'due and payable'. If this interpretation were consistently applied, bond interest, insurance premiums, etc., could be deducted only when due, irrespective of the periods in which they accrue. The inconsistency is most marked in the treatment of deductible taxes. The Board in one case (*Russell Milling Co.'s Appeal*, 1 B. T. A. 194) states:

"'Decision. It is not necessary to enter into a discussion of when taxes accrued further than to say that they can not be accrued until they become due. * * *'

"Needless to say, the foregoing does not accord with the accounting conception of an accrual, nor can it, in the author's opinion, be reconciled with the decision in *U. S. v. Anderson* (269 U. S. 422). The Treasury, however, insists that there is no conflict. (C. B. VI-1, 65; G. C. M. 1240.)"

(pp. 17, 18 and 19) "So-called Reserves.—In many cases items of income are charged with obligations which

must be met before any net taxable income can arise. Under the accrual system of accounting any obligations not discharged at the end of an accounting period are provided for by setting up the equivalent of liabilities in the form of 'reserves,' 'allowances,' 'provisions,' etc. It should be of no consequence what a bookkeeper calls the liability, the only matter of importance is the determination of true net income. The liability must be definite, however, although the amount thereof need not be certain. If the liability is contingent, no deduction is allowed.

* * * * * * *

"Some of the questionable decisions have had to do with paving contracts, land sales, etc., in which the facts were undisputed that the gross income included liabilities which diminished such gross income. The estimates which are necessary to reduce the gross income to substantially correct net income are easier to compute than are estimates for depreciation, obsolescence, and bad debts." [Compare as a justification of this comment by Montgomery the facts and procedure in *Murphy Oil Co. v. Burnet*,— U. S.—77 L. ed. 168 (Adv. Op., Oct. Term, 1932, No. 80).] "But the Treasury and the Board accept and approve such difficult and often highly inaccurate estimates and disallow more accurate estimates.

"It will require a few more court cases to reconcile tax accounting and accurate accounting.

* * * * * * *

"There are many inconsistent rulings and decisions regarding the period to which expenses belong. (See page

14 et seq.) The law provides that expenses shall be deducted in the year when 'incurred'.

* * * * * * * *

"Good accounting practice requires that current gross income be reduced by allowances for contingencies which reasonably can be reduced to figures."

(pp. 21 and 22). "The Treasury in many cases, and the Board at times, have ignored the basic principle in *U. S. v. Anderson* (269 U. S. 422) which is that the early income tax laws were changed to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the *expenses incurred in* and *properly attributable to* the process of earning income during that period. There is no intimation here that allowances for expenses and losses must not be deducted. On the contrary, no language could be clearer. We are told that Congress abandoned its receipt and payment basis and adopted the accrual basis. *Unless estimates were used, there would be no accrual system. When an expense has been 'incurred,' it does not always mean that it has become a legal liability, and when the term 'properly attributable' is used, the words are to be construed according to their ordinary meaning.* If a taxpayer makes a shipment of goods and agrees to pay the freight, there can be no net taxable income until the freight liability is deducted. It certainly was 'incurred' at the moment the income arose; the two elements are inseparable. It certainly was 'properly attributable'. The *Anderson* case makes it clear that accounting principles take care of such items. *There is only one way of doing it, however, and if the Treasury*

and the Board disregard estimates of expenses and liabilities, they ignore the only method known of carrying into effect the changes in the laws which were specifically inserted to take care of accruals.''

(pp. 336 and 337) "The Supreme Court has upheld the duty of taxpayers to include undetermined income. (*Continental Tie & Lumber Co. v. U. S.*, 52 Sup. Ct. 529.) Is it not reasonable to assume that the Supreme Court will uphold the right of a taxpayer to deduct undetermined expenses? (See *Stockbridge's Appeal*, 2 B. T. A. 327 (A); *Gude Bros.' Appeal*, 2 B. T. A. 1029; *Thatcher Co.'s Appeal*, 3 B. T. A. 154.)

"The Board has in some cases been liberal in allowing such deductions. (Retailers Fire Ins. Co.'s Appeal, 3 B. T. A. 1186 (A); Bump Confectionery Co.'s Appeal, 4 B. T. A. 50.)

"Unless such deductions are allowed true net income can never be determined."

Knight, Bookkeepnig, 1930 Ed. pp. 166-167:

"One purpose of bookkeeping is to draw a distinct line between the financial activities of fiscal periods. Each period, whether it be a month, quarter, half-year, or full year, must reflect its own income and expenses and should not contain the income or expenses of another period. * * * A business may also have items of income recorded on its books which have not actually been earned. For example, the organization may have acted as an agent for the selling of real estate and may have charged its client with the commission on the transaction in advance; that

is, with commission which has been not yet earned and will not be earned until the succeeding month or other fiscal period."

Accounting Terminology
Published by American Institute of Accountants.

"Income, Deferred: This term is used in accounting to describe income which has been received but is really applicable to a future period."

Finney, Principles of Accounting, Chapter 2, page 6:

"If the operating profits for the period are to be correctly stated, the Profit and Loss account must be charged with all of the expenses applicable to the period and with no expenses applicable to prior or future periods, and it must be credited with all income applicable to the period and with no income which is really an earning of prior or future periods."

Chapter 2, page 8:

"The rule that profits must not be anticipated is only another way of stating that unrealized profits must not be considered as earned. Attention has already been called to the impropriety of confusing a mere increase in the market value of an inventory with an unearned profit, and to the fact that profits are only earned by sales. Some of the other errors which may result in an anticipation of profits, are:

* * * * * * *

(c) Failing to make provision for deferred credits.

* * *"

Lough, Business Finance, pp. 422-423, 426-427:

"Nearly all well-managed corporations charge against the profits of each year an estimated sum, or a number of distinct estimated sums, which are intended to provide for losses and expenses that will probably arise in the future but which are incident to the operations of the current period. The sums so charged are credited to reserve accounts, which are carried on the balance sheet of the company. As to the nature and use of these reserve accounts, there is much misunderstanding. They do not consist, as people seem sometimes to imagine, of funds of cash or property set aside for the purpose of meeting future expenses. It is, in fact, easily possible that a company may accumulate large reserve accounts and yet be quite unable to meet the anticipated expenses when they actually arise. The essential character of all reserves lies in the fact that they constitute a deduction from profits. The reserves exist only in the form of entries and figures in the company's books of account. It is quite possible that a firm which carries no reserves on its balance sheet may be just as conservatively managed as the one which has large reserves. But the probabilities are the other way, for the reason that proper estimates in favor of reserve accounts assist the officers and stockholders of a company in gauging the true status of the business and therefore discredit exaggerated optimism."

"There are many other kinds of reserves which should be carried if the business of a company is to be based on sound accounting and finance. The business of many companies, for example, requires them to enter into con-

tracts which involve immediate payment on the part of the purchaser of their products, combined with a liability assumed by the company to render future service. A company publishing a magazine usually collects subscription payments in advance and contracts to deliver the magazine over a twelve months' period. This being the case, it is clear that the company actually earns the subscription payment only as it proceeds through the year with the delivery of its magazine, and that it would be improper to credit the subscription payment as income of the week or month in which it is received. The modern custom among magazine publishers is to credit an account usually called 'Unearned Subscriptions' for payments sent in by subscribers, and at the close of each month to debit this account and credit another account called 'Subscription Earnings' for the proportion actually earned by sending out magazines during that month."

Journal of Accountancy, Audits of Accounts of Fire-Insurance Companies, by Felix Hebert, pp. 81, 97-98:

"*Unearned-premium Reserve.*—The unearned-premium reserve is commonly looked upon as a fund sufficient to reinsure all the outstanding risks of a company at any given time. As required to be computed and carried as a liability, this has generally been found to be the case where a company is wound up either through liquidation or receivership proceedings. The better reason for its existence, however, is found in the provisions of fire-insurance-company contracts. In most states fire-insurance companies are prohibited by statute from issuing policies of insurance in any other than the standard forms pre-

scribed. In all these forms there is a provision that the policy may be canceled at any time at the request of the assured, and in that case the company is under obligation to return to the assured a proportion of the premium originally paid, usually on a basis known as a 'short rate' and dependent upon the length of time the policy has been in force. Such contracts also provide that the company may cancel at any time, and when cancellation is effected at the instance of the company the policy holder is entitled to receive the unearned portion of his premium on what is known as the prorata basis, also dependent upon the length of time the policy has been in force. These reinsurance or unearned-premium reserves are prescribed by statute in some states, but every insurance department requires them to be carried as a liability and so uniform is this requirement that the proportion of the premiums in force to be charged as a reserve in liabilities is made a part of the statement blank.

"The calculation of reserves on outstanding premiums is not difficult, though it does involve the consideration of many items. It may be summarized in the following brief statement: Charge every company with a liability for unearned premiums on all risks written for one year or less equal to one-half of the premiums written in the policy in force. In policies for longer terms, the unearned-premium or reinsurance reserve is calculated to be one half of the premium for the current year, and the full premium for the remaining years."

Kester, Accounting—Theory and Practice, 3d Revised Edition, Vol. 1:

(p. 14) "*Accrued Income.* This is the title under which are listed the assets representing the claims against others for income earned to date but not yet due and collectible either because of the terms of the contract governing or because of trade custom or practice."

(p. 17) "*Accrued Expenses.* Accrued expenses represent usually the accumulating but unpaid claims against the business for service rendered it, as distinguished from the Accounts Payable, which usually represent purchases of an assent of one kind or another. The item arises largely because of certain trade practices and customs in accordance with which some kinds of debts are payable periodically."

(p. 30) "Similarly, with regard to the accrued expenses mentioned on page 17, whatever expenses have been incurred that properly belong to the past period, such as wages due but unpaid, are liabilities; for the cash would be smaller by the amount of such postponed or accrued items had the claims been met during the period. The close relationship of both prepaid expenses and accrued expenses to cash is thus apparent—the one as an indirect addition to the cash, the other as an indirect deduction from or claim against cash."

(p. 133) "*Handling Prepaid and Accrued Expenses and Income.* In the buying of supplies and services, quantities are purchased which are seldom completely used up during the current period. Only that portion which the current period consumes should be charged as an ex-

pense of the period. Those portions which will benefit future periods should be deferred as charges to such future periods.

"It is equally important that all supplies and services used by the current period, whether paid for or not, should be charged to the period.

"It is also important that all income earned during the current period, whether actually received or not, should be credited to the current period; *and all income received during the current period but belonging to future periods should be deferred to those periods.*"

(p. 136) "*Adjusting and Closing Deferred Income Account.* Income is sometimes received in advance of its being earned. Banks frequently take interest at the beginning of the loan period rather than at its close; landlords require tenants to pay rentals in advance; and newspapers and magazine publishing companies receive advance payments for subscriptions to papers and periodicals to be furnished in the future. The Rental Income account is a good illustration of the handling of these deferred income items. * * * The adjustment is made by an entry of $250 for unearned rent on the debit side to effect its subtraction from the $300 credit shown in the account, thus reducing it to $50, the portion belonging to the current period. This income of $50 is transferred to the credit of the Profit and Loss account. After the rental income account is ruled off, the deferred income is entered below the ruling on the credit side, forming a part of the earnings of the next period. It is,

however, to be shown among the liabilities in the balance sheet for the current period, usually under the caption of 'Deferred Income', representing the liability of the owner to furnish to his tenant the use of the premises for the full period paid for. * * *

"*Adjusting and Closing Accrued Expense Accounts.* Just as with accrued income items, there is at the close of the fiscal period no record on the books of these accruals of expenses. Accordingly, the record must be made, the account closed, and the new account for the next period must be prepared for convenient entry."

(p. 433) "*Income Under the Accrual Method.* Both accrued and deferred income will be discussed under this head. The item, accrued income, not yet recorded at the close of the fiscal period, arises because in accordance with business custom and practice it is not received till the close of the term during which it is earned. Deferred income on the other hand, arises because it is received in advance of the period of its being earned.

"*Accrued Income.* In booking accrued income, an estimate is first made of the yearly amount of each item of income which cannot be considered as earned solely in the month when the transaction takes place. Thus, income from investments accrues day by day but it may actually be received only a few times during the year. At the close of each month, therefore, one-twelfth of the total estimated yearly amount is brought on the books as a charge to Accrued Income account and a credit to an appropriate income account. This same procedure is followed at the close of each month. When the income is actually received, it is credited to the Accrued Income account

and not to the income account. The Accrued Income account is in the nature of an account receivable and will be in balance at the end of the year if all the estimated income has actually been received by that time. * * *

"*Deferred Income.*—Income, when received in advance of its being earned, is credited to the account, Deferred Income. The title "Unearned Income" is sometimes given to this account. This account reflects the liability of the current period to the future periods which will render the service entitling them to the income. It also reflects the liability of the business to render to the customers, i. e., the payers or contributors of the income, the service or commodity paid for by them in advance. The account is a true liability account and will be carried in the ledger in the liability section. At the end of each month, or other fiscal period, the portion of this income estimated as equitably belonging to the current period will be transferred from the Deferred Income account to an appropriate income account set up in the temporary proprietorship section of the ledger. * * *

"*Expense Under the Accrual Method.*—Both accrued and deferred or prepaid expenses will be considered here.

Accrued Expense.—For expenses where the period of accrual, before settlement is made, is for more than one month—as in the case with interest on bonds payable or with royalty expense paid every six months or once a year—at the end of each month an estimate is made of the

amount accrued during the current month. The following entry, in the case of royalties, is made of this amount:

Royalty Expense.....xxx
Accrued Expenses.....xxx

At the end of the contract period when payment is made, Accrued Expenses account will be charged, no entry being made at that time to Royalty Expense account. As in the case of accrued income explained above, care must be used to make sure that the expense for the entire period has been recorded in the Accrued Expense account before entry is made of the payment."

Kester, Accounting—Theory and Practice, 1921 Ed., Vol. 2:

(p. 343) "*Deferred Income.*—This income comprises the items of income received in advance of the full performance of the service required to earn it. In cases of this kind there are in possession of the business certain assets which must be used to perform the service not yet completed in order to entitle the business to the full enjoyment of income. That is, the property of the owners is liable for the service not yet rendered. Also, in order to make a correct showing of results as between the current fiscal year and the next, this unearned income must be carried forward for credit in the period in which the service is performed."

Wiegand, Fire Insurance Accounting:

At page 56 the author discusses what he calls "the most important liability of a fire insurance company" "the unearned premium reserve". He gives three reasons "for

this obligation. The first is the accounting principle which cautions against anticipating earnings; * * *. The second reason is the provision in the standard form of policy whereby the contract may be cancelled by either party. * * * The third reason for the unearned premium liability is an express provision of the insurance law dealing with the determination of liabilities."

The author then takes up, and at pages 57-66 discusses, the methods of determining this reserve. He says, "in theory it is regarded that all policies are written on the fifteenth day of the month in which they are issued, to expire on the fifteenth day of the same month one or more years later." He then shows how the fractions representing the unearned portion of any premium may be arrived at on a monthly basis (pages 57-60), and goes on:

"*Two methods of determining liability.* Of the two methods of applying the fractions previously mentioned, the first, or the annual basis, consists of totaling the number of half months in the column for each year, as is shown below, and then dividing each total by twelve to obtain an average fraction for the year. At the close of 1923 the unearned fractions on policies during the various months of that and previous years and expiring in the years indicated are computed in the manner shown in the tabulation in figure 7. (We omit this.)

"The final fractions are those printed in the supporting schedule of the convention blank *and are the same as would be obtained if all policies were considered as written on June 30 and expiring on the same date one or more years later.*

"On this basis policies issued during the year 1923 will have unearned premium fractions at December 31, 1923, as shown in the table in Figure 8.

Term of Policies-Years	Year of Expiration	Months Earned	Months Unearned	Fraction Unearned December 31, 1923
1	1924	6	6	1/2
2	1925	6	18	3/4
3	1926	6	30	5/6
4	1927	6	42	7/8
5	1928	6	54	9/10

Figure 8. Table Showing Fractions of Unearned Premiums on Annual Basis

"These fractions are applied to the total net premiums in force in each year to give the amount unearned."